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No. 91-1822

IN THE
Supreme Court of the United States
OCTOBER TERM, 1991

LA ISLA VIRGEN, INC.,
Petitioner,

v.

ANTHONY P. OLIVE, Director of the Virgin Islands Bureau of Internal Revenue, and GOVERNMENT OF THE VIRGIN ISLANDS,
Respondents.

Petition for a Writ of Certiorari to the United States Court of Appeals for the Third Circuit

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PETITION FOR A WRIT OF CERTIORARI

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QUESTIONS PRESENTED

1. Whether the imposition of negligence penalties on a taxpayer who it is conceded relied upon its tax counsel with respect to the extent of its income tax liability is contrary to law and in conflict with *United States v. Boyle*, 469 U.S. 241 (1985).

2. Whether and, if so, by what authority the Virgin Islands can apply United States Internal Revenue Code procedural and administrative provisions not adopted or otherwise enacted into law in the Virgin Islands.

3. Whether the Virgin Islands can collect income tax on non-Virgin Islands source income attributable to transactions specified in Section 1277(c)(2)(E) of the Tax Reform Act of 1986 even though the Congress in that Act generally deprived the Virgin Islands of the authority to collect tax on non-Virgin Islands source income for the years at issue.

4. Whether the court may recharacterize for tax purposes one step of an integrated transaction without proper consideration of the overall transaction under applicable tax law principles, including application of the step transaction doctrine and, if not, whether an appropriate analysis has been made in this case.

LIST OF PARTIES AND RULE 29.1 LIST

The parties to the proceedings below and before this Court are the petitioner, La Isla Virgen, Inc., and the respondents, Anthony P. Olive, Director of the Virgin Islands Bureau of Internal Revenue, and the Government of the Virgin Islands.

Petitioner was merged in 1988 into Marina Pacifica Oil Company, a California corporation ("MPOC") in a reorganization under Section 368(a)(1)(A) of the Internal Revenue Code of 1986 (the "Internal Revenue Code"). MPOC was the surviving entity in said merger. On March 17, 1992, MPOC was merged into Lonesome Dove Petroleum Co., a Texas corporation ("LDPC") in a reorganization under Section 368(a)(1)(F) of the Internal Revenue Code. LDPC was the surviving entity in said merger. LDPC has one wholly-owned subsidiary, M.P. Oil Company.

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PETITION FOR A WRIT OF CERTIORARI

The petitioner La Isla Virgen, Inc. respectfully prays that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Third Circuit, entered in the above entitled proceeding on December 17, 1991.

OPINIONS BELOW

Three opinions and orders comprise the history of this case. The judgment of the Court of Appeals for the Third Circuit is reprinted in the Appendix, p. 1a, *infra*. The Court of Appeals for the Third Circuit by order dated January 14, 1992 denied the petitioner's petition for rehearing and for rehearing *en banc*. Appendix, p. 12a, *infra*. The memorandum decision of the United States District Court for the District of the Virgin

Islands (Giles, D.J.) has not been reported. Appendix, p. 3a, *infra*.

JURISDICTION

Invoking federal jurisdiction under 48 U.S.C. Section 1612(a) (Supp. 1985) and 33 Virgin Islands Code Section 944 (1967), the petitioner sought redetermination of its income tax liability in the District Court of the Virgin Islands. On February 28, 1991, the district court granted summary judgment in favor of the respondent. *See* p. 12a, *infra*.

On petitioner's appeal, the Third Circuit Court of Appeals on December 17, 1991 affirmed the decision of the district court. Petitioner timely filed a petition for rehearing and rehearing *en banc*, which was denied on January 14, 1992.

Upon proper application, on March 25, 1992, Associate Justice David H. Souter ordered that the time for filing this petition for writ of certiorari be extended to and including May 13, 1992. *See* p. 14a, *infra*.

The jurisdiction of this Court to review the judgment of the Third Circuit is invoked under 28 U.S.C. Section 1254(1).

STATUTES INVOLVED

48 U.S.C. § 1642 (Supp. 1981)
48 U.S.C. § 1397 (1976)

Tax Reform Act of 1986:

Section 1275(b)
Section 1277(c)(2)(A), (B), (C), and (E)

IRC Section 6653(a)
IRC Section 6662(c)
IRC Section 6661 (repealed)

These statutes are set out verbatim in the Appendix.

STATEMENT OF THE CASE

Petitioner was incorporated in the State of Delaware on March 6, 1981 and qualified to do business in the Virgin Islands on June 1, 1981. During all times relevant petitioner was an "inhabitant" of the Virgin Islands pursuant to Section 28(a) of the Revised Organic Act of the Virgin Islands, 48 U.S.C. Section 1642 (Supp. 1981) (hereinafter "Revised Organic Act"). *See* p. 17a, *infra*. As an inhabitant corporation, petitioner filed its annual federal income tax return with respondent. Petitioner's returns reported its income from all sources, but did not treat income from sources outside the Virgin Islands as taxable income. Instead, petitioner reported that income as non-taxable foreign source income.

On May 13, 1986, May 10, 1987 and October 13, 1987 respondent issued deficiency notices asserting that petitioner owed additional income tax for fiscal years 1982-1986 all of which is attributable to its non-Virgin Islands source income. On July 21, 1986, January 11, 1988 and August 5, 1988 petitioner petitioned the District Court of the Virgin Islands for redetermination of its income tax liabilities. The district court consolidated the actions by Order dated April 12, 1990.

On February 28, 1991, the district court denied petitioner's motion for summary judgment and granted respondent's cross motion for summary judgment. *See* p. 3a, *infra*. On petitioner's appeal, the Third Circuit, on December 17, 1991, entered a judgment affirming the district court's judgment. On December 31, 1991 petitioner filed a petition for rehearing and for rehearing *en banc*. On January 14, 1992 the Third Circuit denied the petition for rehearing and rehearing *en banc*. See p. 12a, *infra*.

It is stipulated that the decision to form petitioner and establish it for United States income tax purposes as an inhabitant corporation in the Virgin Islands was based on an analysis by petitioner's legal counsel as to the so-

called "inhabitant rule" concerning federal income tax liabilities in the Virgin Islands. *See* p. 35a, *infra*.

William M. Lansdale, a resident of California, owned 100 percent of petitioner's capital stock from its incorporation [1] in 1981 until its statutory merger into Marina Pacifica Oil Company in 1988. Lansdale served as a director and officer of petitioner throughout that period and was president at the time of the merger.

Early in 1981 Lansdale's accountant, Stephen L. Newman, C.P.A., who was familiar with a Tax Management, Inc. portfolio entitled *Business Operations in the U.S. Virgin Islands*,[2] authored by Gustav A. Danielson, a tax lawyer and accountant in the Virgin Islands, advised Lansdale that the inhabitant rule was a "wrinkle" in federal tax law that allowed United States corporations to get involved in the Virgin Islands and realize certain tax advantages not otherwise available. *See* p. 23a-24a, *infra*. Lansdale then contacted his attorney, Rufus v. Rhoades, who is a published authority on foreign aspects of United States income tax law and related tax planning. *See* p. 33a, *infra*. Lansdale asked Rhoades to investigate the claimed tax advantages associated with the inhabitant rule and advise him. After speaking with Lansdale's accountant, Rhoades read the Danielson Tax Management, Inc. portfolio, and spoke with Danielson by telephone. Later, at Lansdale's request, Rhoades travelled from California to the Virgin Islands where he conferred at length with Danielson. *See* p. 34a, *infra*. As a result, Rhoades was satisfied that Danielson's analysis of the inhabitant rule was sufficiently valid to pursue. After

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[1] All of petitioner's capital stock was issued to William M. Lansdale and Marianthi Lansdale, husband and wife, as community property in accordance with California law. Mrs. Lansdale had no involvement in any substantive aspect of the transactions at issue nor in petitioner and its corporate successors in interest generally.

[2] Danielson, 336-2nd T.M., *Business Operations in the U.S. Virgin Islands* (1985).

discussing Danielson's analysis with Rhoades, Lansdale retained Danielson in early March of 1981 to implement the formation of petitioner and its establishment as a Virgin Islands inhabitant corporation.

Danielson reviewed Lansdale's income tax situation with respect to certain pending transactions involving a disposition of Lansdale's interests in a California limited partnership known as Marina Pacifica, which owned a 38 acre tract of real property located in Long Beach, California. Danielson researched the relevant issues, formulated a comprehensive plan to minimize income tax liabilities, and rendered a formal written opinion dated September 25, 1981 confirming his previous oral advice concerning the proposed plans. *See* p. 34a and 35a; *see also*, p. 58a, *infra*. Danielson on June 15, 1982 rendered a second written opinion with respect to petitioner's reporting requirements under the Internal Revenue Code and the tax treatment of petitioner's interest and royalty income. *See* p. 34a and 35a; *see also*, p. 86a, *infra*. It is stipulated that Danielson "architected" the entire transaction whereby Lansdale assigned to petitioner his distribution rights with respect to the pending disposition of the Long Beach and related properties. *See* p. 35a, *infra*.

Less than a week after petitioner was incorporated, Lansdale assigned petitioner his contract rights to distributions to be made by Marina Pacifica upon the partnership's disposition of the Long Beach property. Several months before petitioner's incorporation, Lansdale, who was the sole limited partner, and the corporate general partner, Southern California Financial Corp., had completed negotiations with C. Robert Langslet & Son, Inc., an unrelated party ("Langslet"), for the sale of the property. *See* p. 20a and 21a, *infra*. Shortly after Lansdale's assignment to petitioner, the Long Beach property was acquired by Langslet under the terms previously

agreed to on December 16, 1980.[3] A chronological outline of events relating to the disposition of the Long Beach property is set out in the Appendix at page 37a, *infra*.

During the fiscal years at issue, petitioner filed its corporate income tax returns annually with respondent reporting as nontaxable foreign source income all income from sources without the Virgin Islands. Petitioner reported its non-Virgin Islands source income in this manner relying on the advice of its legal counsel's opinion dated June 15, 1982. *See* p. 86a, p. 34a and 35a, *infra*.

On October 22, 1986, Congress enacted the Tax Reform Act of 1986, Pub. L. No. 99-514, (codified as amended in scattered sections of 26 U.S.C.) (hereinafter "TRA 86"). It included certain provisions designed to repeal retroactively the inhabitant rule and close the tax loophole found by the district court in *Danbury, Inc. v. Olive*, 627 F. Supp. 513 (D.V.I. 1986), *rev'd*, 820 F.2d 618 (3d Cir. 1987), *cert. denied*, 484 U.S. 964 (1987). Before enactment of those provisions, petitioner sought relief from any action which would require it to pay tax on its non-Virgin Islands source income attributable to the transactions involving the Long Beach property. Congress responded to petitioner's concerns by enacting TRA 86 Section 1277(c)(2)(E), which granted petitioner a "targeted exception" that specified the covered transactions and the maximum aggregate dollar amount of the tax relief provided petitioner. *See* p. 32a, *infra*.[4]

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[3] The transaction was structured formally as a contirbution by petitioner of the assigned distribution rights to a newly formed limited partnership, Pacifica Properties, in exchange for a 24 percent limited partnership interest of which 23/24's (96 percent) was to be immediately redeemed for $3,000,000 cash, $4,000,000 in promissory notes and certain oil interests. The cash and notes distributed to petitioner by the new partnership were contributed to the partnership for that purpose by Langslet.

[4] The parties have stipulated that petitioner is the corporation described in Section 1277(c)(2)(E). *See* p. 32a, *infra*.

Two aspects of the district court's memorandum decision below require close scrutiny:

First, the court held petitioner liable for negligence penalties under Internal Revenue Code Section 6653(a) and rejected petitioner's reliance on *United States v. Boyle*, 469 U.S. 241 (1985) and the stipulation that it relied on advice of its legal counsel in determining its tax liability, which precludes imposition of penalties for negligence.[5] *See* p. 9a, *infra*. In rejecting petitioner's position the district court stated (p. 10a, *infra*)

> [I]f [petitioner's] legal counsel was negligent, [petitioner] would be liable under this section. There is no showing that [petitioner's] counsel was other than negligent.

The court did not discuss or explain how negligence penalties could be imposed in view of the stipulated reliance on legal counsel. In addition, the court provided no authority for its concluding that negligence by a taxpayer's legal counsel required, without more, a finding of negligence by the taxpayer.

Second, in rejecting petitioner's position that respondent lacks authority to apply Internal Revenue Code procedure and administrative provisions, including penalties, the court stated (p. 9a and 10a, *infra*)

> However, [petitioner] overlooks the fact that the Virgin Islands Tax Code applies to Virgin Islands taxes. The taxes upon which the VIBIR bases these penalties are due on stateside income. Therefore, the United States Tax Code provides the appropriate authority.

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[5] Section 6653(a) was revised by Section 1503(a) of TRA 86 in an effort to make the negligence penalty clearer and more comprehensible. See H.R. Rep. No. 426, 99th Cong., 1st Sess. 834, reprinted in 1986 U.S. CODE CONG. & ADMIN. NEWS 4868. Section 6653(a) as it read during the years at issue is reprinted in the appendix. *See* p. 55a, *infra*.

Again, the court cited no authority for this position, which contradicts the Third Circuit's observation in *Chicago Bridge and Iron Co. v. Wheatley*, 430 F.2d 973, 975 n.2 (3d Cir. 1970), *cert. denied*, 401 U.S. 910 (1971), that the provisions of the Virgin Islands Code, including those relating to penalties, are the procedural and administrative provisions applicable to the United States income tax.

REASONS FOR GRANTING THE WRIT

I. THE IMPOSITION OF NEGLIGENCE PENALTIES ON A TAXPAYER WHO REASONABLY RELIED ON THE ADVICE OF LEGAL COUNSEL WITH RESPECT TO A MATTER OF SUBSTANTIVE TAX LAW CONFLICTS WITH DECISIONS OF THIS COURT AND OTHER CIRCUITS.

Petitioner has been found liable for negligence penalties based solely on a finding that petitioner's legal counsel were negligent.[6] *See* p. 10a, *infra*. In so holding, the court resurrected the long discredited proposition that a taxpayer who obtains and relies upon legal advice concerning a substantive matter of tax law may be charged *cum onere* with that counsel's negligence. *Haywood Lumber & Mining Co. v. Commissioner*, 178 F.2d 769, 771 (2d Cir. 1950). The Third Circuit's affirmation of this holding, without opinion, requires this Court's review upon certiorari.

"Negligence," as defined by Congress for tax purposes, "includes any failure to make a reasonable attempt to comply with the provisions of this title." I.R.C. § 6662(c)

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[6] Petitioner does not dispute respondent's authority to impose penalties for negligence or late filing because, although the deficiency notices assert those penalties are imposed under Internal Revenue Code Sections 6653(a) and 6651, those provisions have been adopted into Title 33 of the Virgin Islands Code, Sections 1283(a) and 1281, respectively, and the operative language is, in material part, identical. *See* p. 40a, *infra*, showing the derivation source for procedural and administrative tax law in the Virgin Islands.

(1991).[7] In including that definition in the 1986 Tax Reform Act (P.L. 99-514, Oct. 22, 1986) Congress specifically left undisturbed the extensive body of decisional case law that has addressed the negligence issue. *See* p. 56a, *infra*. In general, negligence is measured by the "reasonable, prudent person standard." *Betson v. Commissioner*, 802 F.2d 365, 372 (9th Cir. 1986) (citing *Zmuda v. Commissioner*, 731 F.2d 1417, 1422 (9th Cir. 1984)); *Sammons v. Commissioner*, 838 F.2d 330, 337 (9th Cir. 1988). Consistent with that standard is a fair consideration of the taxpayer's good faith reliance on expert advice and counsel. *Hanson v. Commissioner*, 696 F.2d 1232, 1234 (9th Cir. 1983) (citing *Conlorez Corp. v. Commissioner*, 51 T.C. 467, 475 (1968)).

This Court has made clear that a taxpayer's reliance on legal counsel with respect to an interpretation of a statute cannot be equated with a taxpayer's duty to comply with an unambiguous statutory directive regarding the filing of a tax return. *United States v. Boyle*, 469 U.S. 241, 251 (1985). However, in considering the reasonableness of reliance on counsel in that statutory context, the Court went to great lengths to distinguish a case where a taxpayer relied on the erroneous advice of counsel concerning a substantive question of law. *Boyle*, 469 U.S. at 250. *Boyle* noted that courts have "frequently" held that reasonable reliance on the advice of an accountant or attorney establishes "reasonable cause," even where such advice proves mistaken. *Id.* The Court, in language particularly relevant to the petitioner's circumstances said:

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[7] The Omnibus Budget Reconciliation Act of 1989 (P.L. 101-239, December 19, 1980) consolidated into new Code Section 6662 all of the generally applicable penalties relating to the accuracy of tax returns, including the penalty provisions for negligence formerly set out in Section 6653(a). The statutory definition of negligence formerly contained in Section 6653(a)(1)(C) is now set forth in Section 6662(c).

> When an accountant or attorney *advises* a taxpayer on a matter of tax law, such as whether a liability exists, it is reasonable for the taxpayer to rely on that advice. Most taxpayers are not competent to discern error in the substantive advice of an accountant or attorney. To require the taxpayer to challenge the attorney, to seek a "second opinion," or to try to monitor counsel on the provisions of the Code himself would nullify the very purpose of seeking the advice of a presumed expert in the first place. [*Id.* at 251, emphasis original]

Consequently, imposing negligence penalties on the petitioner on the record here completely repudiates the directive of *United States v. Boyle* because it is stipulated that petitioner was formed and subsequently adopted its tax return position in complete reliance on the advice of its tax counsel. *See* p. 34a, 35a, *infra*. Moreover, the complexity of the Virgin Islands tax regime known as the "mirror Code", which can be seen even from the abbreviated summary of the District Court, virtually mandates a conclusion that petitioner's reliance was "reasonable." *See* p. 6a, *infra*. Petitioner's reliance on expert tax advice as to whether it had a tax liability to the Virgin Islands with respect to non-Virgin Islands source income is reasonable cause for any understatement of tax based on such income.

Not only was petitioner given legal advice on the application of federal income tax laws in the Virgin Islands from a Virgin Islands tax lawyer who, at the time, was the leading authority on that topic, petitioner obtained a second opinion from its United States tax counsel, Rufus v. Rhoades. Petitioner's reliance on Gustav Danielson's advice was, in turn, founded upon its reliance on Rhoades. Petitioner hired Rhoades to evaluate Danielson's advice, and there is nothing in the record to support a finding that Rhoades was negligent in the advice he gave petitioner evaluating Danielson's analysis of the inhabitant rule and the tax planning opportunity it afforded. To the

contrary, Rhoades' expert status as well as his extensive activities in connection with rendering advice to petitioner are also stipulated. *See* p. 33a-34a, *infra.*

In *Boyle*, this Court also said that a taxpayer is not required to challenge its counsel, and seek a second opinion to establish reasonable cause with respect to a substantive matter of tax law, such as whether a liability, in fact, exists. The Third Circuit's affirmance, however, goes even further by imposing negligence penalties on a taxpayer who *does* obtain a second opinion and then from a nationally recognized tax specialist. Almost 50 years ago this Court, in *Spies v. United States*, 317 U.S. 492 (1943), noted the complexity of federal tax law and the rules regarding proper treatment of various items for tax purposes. It stated

> It is not the purpose of the law to penalize frank difference of opinion or innocent errors made despite the exercise of reasonable care. Such errors are corrected by the assessment of the deficiency of tax and its collection with interest for the delay. [*Spies*, 317 U.S. at 496].

The district court's holding that petitioner is liable for negligence penalties despite its reasonable reliance on the advice of legal counsel not only conflicts with *Boyle*, it also conflicts with several circuit court opinions. *Haywood Lumber and Mining Co.* v. *Commissioner*, 178 F.2d 769, 771 (2nd Cir. 1950); *Hanson v. Commissioner*, 696 F.2d 1232, 1234 (9th Cir. 1983); *United States v. Kroll*, 547 F.2d 393, 395-396 (7th Cir. 1977); *Commissioner v. S.A. Woods Machinery Co.*, 57 F.2d 635, 636 (1st Cir. 1932), *cert. denied*, 287 U.S. 613 (1932), and *Burton Swartz Land Corp. v. Commissioner*, 198 F.2d 558, 560 (5th Cir. 1952). The holding also conflicts with numerius decisions of the United States Tax Court. *See, e.g., Industrial Valley Bank and Trust Co. v. Commissioner*, 66 T.C. 272, 283 (1976); *Conlorez Corp. v. Commissioner*, 51 T.C. 467, 474-475 (1968), *Erhard v. Commissioner*,

T.C. Memo 1991-290, 62 T.C.M. (C.C.H.) 1, 29 (Negligence penalties not imposed notwithstanding disallowance of claimed deductions by a taxpayer who relied on a team of attorneys and other competent tax professionals). Petitioner seeks a writ of certiorari because to leave undisturbed the Third Circuit's summary affirmance would resurrect a strict liability theory of tax negligence once characterized by the Third Circuit as "an inconceivable proposition," *Hatfried, Inc. v. Commissioner*, 162 F.2d 628 at 635 (3rd Cir. 1947). Finding petitioner liable for negligence penalties despite its acknowledged reliance on legal counsel not only rejects applicable precedent, but would be "contrary to natural justice." *Orient Investment & Finance Co. v. Commissioner*, 166 F.2d 601, 603 (D.C. Cir. 1948).

II. RESPONDENT HAS NO AUTHORITY TO IMPOSE PENALTIES UNDER INTERNAL REVENUE CODE PROVISIONS THAT ARE NOT PART OF THE PROCEDURAL AND ADMINISTRATIVE TAX LAW OF THE VIRGIN ISLANDS.

Respondent's deficiency notices seek to impose penalties on petitioner for substantial understatement of income tax with respect to fiscal years 1982, 1983, 1984, and 1985. Respondent asserts authority to impose these penalties pursuant to former Internal Revenue Code Section 6661.[8] Specifically, respondent contended, and the district court found that it may apply Internal Revenue Code procedural and administrative provisions to the petitioner because the taxes allegedly understated are attributable to income from United States sources. *See* p. 10a, *infra*.

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[8] Section 6661 was repealed by Section 7721(c)(2) of the Omnibus Budget Reconciliation Act of 1989 (Pub. L. No. 101-239, December 19, 1989). Section 8002 of the Omnibus Budget Reconciliation Act of 1986, (Pub. L. No. 99-509, October 21, 1986) increased the penalty from 10 percent to 25 percent for taxes assessed after October 21, 1986. Respondent seeks to impose the 25 percent penalty on petitioner.

This holding was incorrect because procedural and administrative provisions of the Internal Revenue Code, including the penalty provisions of Section 6661, are not "applicable taxing statutes" of the United States available to respondent pursuant to Revised Organic Act Section 28(a). *See* p. 46a, *infra*. The ramifications of this holding extend far beyond this case and affect every person subject to federal income tax in the Virgin Islands. It is crucial, therefore, that this issue be resolved because respondents' position leads to the absurd result that a Virgin Islands taxpayer is subject to Internal Revenue Code procedural and administrative provisions on United States source income and subject to the procedural and administrative provisions contained in Title 33, Part II of the Virgin Islands Code on its Virgin Islands source income.

Respondent's authority to assess federal income tax liabilities on Virgin Islands residents is found in the Naval Appropriations Act of 1921 (48 U.S.C. Section 1397) and Revised Organic Act Section 28(a). The Naval Appropriations Act imposed United States income tax in the Virgin Islands by providing:

> The income tax laws in force in the United States of America and those which may hereafter be enacted shall be held to be likewise in force in the Virgin Islands of the United States, except that the proceeds of such taxes shall be paid into the treasuries of the said islands.

The Revised Organic Act Section 28(a) is considered to be the source of the "inhabitant rule." This is because in addition to providing that, *inter alia*, United States income tax collections be paid over to the Virgin Islands treasury, and defining Virgin Islands "inhabitants" as being all persons whose permanent residence is the Virgin Islands, the statute directs that such inhabitants:

> [S]hall satisfy their income tax obligations under applicable taxing statutes of the United States by

> paying their tax on income derived from all sources both within and outside the Virgin Islands into the treasury of the Virgin Islands. *Id.*

In construing this language in *Danbury, Inc. v. Olive*, 820 F.2d at 622-623, the Third Circuit held that:

> " '[I]ncome tax obligations under the applicable taxing statutes of the United States' in Section 28(a) means just that—taxes owed under applicable principles of the non-mirrored Internal Revenue Code."

However, respondent's authority to determine petitioner's income tax obligations under applicable principles of the non-mirrored Code does not include authority to apply Internal Revenue Code provisions, such as the procedural and administrative provisions in Subtitle F, that are not "applicable taxing statutes" of the United States. Plainly, Section 6661 is such a provision because it does not impose a tax; where applicable, the statute imposed a penalty by way of an *addition* to tax.

Respondent's authority to apply Internal Revenue Code provisions is limited to those substantive provisions contained in Subtitle A comprising the income tax laws of the United States. Plainly, respondent has no authority with respect to other portions of the Internal Revenue Code that are not "income tax law" within the meaning of the Naval Appropriations Act.[9] The procedural and administrative tax laws available to respondent are not those

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[9] For example, respondent may not assess or collect estate and gift taxes (Subtitle B), employment taxes (Subtitle C) miscellaneous excise taxes (Subtitle D), or alcohol, tobacco and miscellaneous taxes (Subtitle E). All of these subtitles generate tax proceeds, but such proceeds are not paid into the Virgin Islands treasury, regardless of whether attributable to Virgin Islands persons or transactions. The procedural and administrative provisions in Subtitle F apply generally in all these areas. For example, Section 6501(a) requires that "any tax imposed by this title" be assessed within 3 years after the return is filed, and otherwise where the tax is payable by stamp.

available to the United States Internal Revenue Service in Subtitle F of the Internal Revenue Code, but, rather, those found in Part II of Title 33 of the Virgin Islands Code.

Describing the two-part structure of Title 33, the Third Circuit, in *Chicago Bridge & Iron Co. v. Wheatley*, 430 F.2d 973 (3d Cir. 1970), stated:

> Subtitle I of Title 33 contains two parts. Part I sets forth the substantive provisions of certain locally imposed taxes, such as inheritance, excise, gasoline, stamp, and production taxes. *Part II comprises procedural and administrative provisions applicable to all Virgin Islands taxes, including the United States income tax.* As pointed out in the text at the beginning of this opinion, the *substantive* provisions of the Internal Revenue Code were made applicable in the Virgin Islands by congressional enactment in the Naval Service Appropriation Act of 1921.

Id. at 975 n.2 (citation omitted, emphasis supplied).

Substantive provisions of United States income tax law apply in the Virgin Islands under the authority of the Naval Appropriations Act and the Revised Organic Act. However, the Virgin Islands had to adopt procedural and administrative tax laws, and did so in Title 33, Part II. Thus, although much of Part II is derived from Subtitle F of the Internal Revenue Code, it is not a wholesale adoption.[10]

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[10] The legislative history note to Part II states:

> In most instances the wording of the Internal Revenue Code has been followed exactly, but in a number of sections changes of varying degrees were necessary to conform the section with the legal and administrative structure of the Virgin Islands or with the requirements of the Revised Organic Act of the Virgin Islands. *Changes were also made to remove references to provisions of the United States Internal Revenue Code which are not applicable to the Virgin Islands*, to convert certain terminology into that used in the Virgin Islands, and to integrate the

Plainly, the so-called "equality principle" of *Chicago Bridge & Iron* is inapposite to the issue of what procedural and administrative provisions respondent may apply because the equality principle has to do with substantive equality of income tax treatment. *Chicago Bridge & Iron*, 430 F.2d at 977. In *U.S. Virgin Islands and Broderick v. Bank of America*, 17 V.I. 594 (D.V.I. 1980), the Virgin Islands District Court concluded that the procedural and administrative tax law of the Virgin Islands was, in effect, co-extensive with Subtitle F of the Internal Revenue Code, so that amendments made by Congress to Subtitle F were incorporated automatically into Part II of Title 33. *Broderick*, 17 V.I. at 596. However, *Broderick*'s flawed analysis seems to rest on its concern that Virgin Islands inhabitants "are relegated to a sort of second class citizenship." *Broderick*, 17 V.I. at 596.[11]

It is crucial for this Court to declare what procedural and administrative tax law applies in the Virgin Islands. The imposition of penalties is a part of the procedure and administration of tax laws. Neither Congress, in enact-

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provisions of this Part with those of Part I of this subtitle. (emphasis added.)

No less than 13 sections of Part II initially came from sources other than Subtitle F of the Internal Revenue Code; two sections were derived from other titles in the United States Code and the others are derived from Virgin Islands law. *See* p. 40a, *infra* (Derivation Table). Because Part II, when enacted, did not contain all of Subtitle F and also contained provisions not included in Subtitle F, it is impossible to characterize Part II as a mirror Code reflection of Subtitle F.

[11] The Internal Revenue Code provision at issue in *Broderick* was Section 7609, which, in applicable circumstances, gives third parties intervenor rights in tax cases. Curiously enough, the Virgin Islands Department of Justice, on behalf of respondent's predecessor agency, the Department of Finance, made the same argument now made by petitioner; i.e., that the only procedural rules in effect in the Virgin Islands are those contained in Part II of Ttitle 33 of the Virgin Islands Code.

ing the Revised Organic Act, nor the Third Circuit, in deciding *Chicago Bridge & Iron* contemplate a system where Internal Revenue Code statutory penalties and other procedural rules apply on an *ad hoc* basis to Virgin Islands taxpayers depending on whether a given United States income tax liability relates to income from within or outside the Virgin Islands.

III. THE VIRGIN ISLANDS HAS NO AUTHORITY TO COLLECT INCOME TAX WITH RESPECT TO NON-VIRGIN ISLANDS SOURCE INCOME ATTRIBUTABLE TO TRANSACTIONS SPECIFIED IN SECTION 1277(c)(2)(E) OF THE TAX REFORM ACT OF 1986

Congress repealed the inhabitant rule in Section 1275(b) of TRA 86, by providing that Revised Organic Act Section 28(a) shall be effective as if it had been enacted prior to the Internal Revenue Code and by declaring that it would have no effect on the amount of income tax to be paid by any person to the United States. *See* p. 48a, *infra*. Congress also provided in Section 1277(c)(2) of TRA 86 that its action in Section 1275(b) was to apply retroactively to years not barred by an applicable statute of limitations. *See* p. 48a, *infra*. In addition, Congress deprived the Virgin Islands of the right to collect the tax revenue generated by retroactive repeal by providing that only taxes paid to the Virgin Islands on or before the date of enactment would be credited against the taxpayer's liability to the United States with respect to non-Virgin Islands source income. TRA Section 1277(c)(2)(B)(ii). *See* p. 48a-49a, *infra*. Except for a limited provision,[12] which does not apply to petitioner, Congress left the Virgin Islands with no basis to collect

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[12] TRA Section 1277(c)(2)(B) provides that any tax paid to the Virgin Islands before January 1, 1987, pursuant to a process in effect before August 16, 1986, shall be treated as paid before the date of enactment.

any tax due with respect to the non-Virgin Islands source income of United States corporations.

In recognition of petitioner's unique circumstances Congress provided it an exception—with respect to certain specified transactions—from the retroactive repeal of the inhabitant rule. TRA 86 1277(c)(2)(E). *See* p. 49a, *infra*. Congress provided relief to petitioner and to another similarly situated corporation because it believed that the nature and extent of their activities in the Virgin Islands warranted protection from an income tax liability on non-Virgin Islands source income.

In *Bizcap, Inc. v. Olive*, 892 F.2d 1163 (3d Cir. 1989), *cert. denied sub nom. Caribbean Marine, Inc. v. Olive*, 496 U.S. 905 (1990), the Third Circuit, citing *Danbury, Inc. v. Olive*, 820 F.2d at 622, held that the targeted exception provided to that taxpayer only exempted it from the retroactive effect of the tax law change, leaving it liable to respondent for tax on its non-Virgin Islands source income. However, because Congress, in TRA 86, deprived respondent of the authority to collect such a tax, to the extent attributable to years covered by the retroactive repeal, the district court erred in holding that respondent can collect any tax due on that income. Consequently, even though *Bizcap* provides that the corporation *owed* tax on its non-Virgin Islands source income independently of TRA 86, Congress' action in TRA 86 requires that any such tax only can be collected by the United States, not the Virgin Islands.

Congress' mandate that any tax owed by petitioner is payable only to the United States also is seen by the specific language limiting the tax relief to $8,312,000. The statutory language in subparagraph 1277(c)(2)(E)(iii) states that if petitioner's aggregate tax relief exceeds that amount, the excess shall be attributed to income received in taxable years in *reverse* chronological order. Obviously, this provision for tax on the excess amount is a provision for tax by the United States Internal Revenue Service,

not respondent.[13] Allowing respondent to collect this tax revenue from petitioner ignores entirely this explicit provision.

Only Congress can authorize the Virgin Islands to collect federal income tax on non-Virgin Islands source income of United States corporations. In TRA 86, Congress terminated that authority as to the years at issue here. Nothing in that Act or in any other Congressional statute revives that authority. The effect of TRA 86 was to deny the Virgin Islands the power to collect United States income tax for the open years. *Danbury, Inc. v. Olive*, 820 F.2d at 627. The Third Circuit did not consider this point in deciding *Bizcap* and, for that reason erred in its statutory analysis. *Bizcap* is wrong insofar as it authoizes collection by the Virgin Islands of revenue which Congress has clearly said belongs to the United States.

IV. RECHARACTERIZATION OF THE MARINA PACIFICA TRANSACTIONS FOR TAX PURPOSES AS A DISGUISED SALE BY PETITIONER WITHOUT PROPER CONSIDERATION OF APPLICABLE TAX LAW PRINCIPLES IS WHOLLY INCOMPATIBLE WITH ESTABLISHED PRECEDENT.

Even if the targeted exception provided petitioner by Congress in TRA 86 did not bar the tax assessments at issue, it would still be necessary to determine whether petitioner is liable for tax on gain attributable to the specified transactions. These transactions took the form of transfers of partnership assets with a simultaneous redemption of associated limited partnership interests. Under long settled substantive principles of income tax law petitioner cannot be treated as the taxpayer liable for

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[13] By attributing any excess income to years in reverse chronological order Congress sought to preclude the possibility that the Internal Revenue Service would be barred from assessing tax on that income by expiration of the statute of limitations.

gain on these transactions. The district court recharacterized these transactions as a disguised sale by petitioner. *See* p. 9a, *infra*. However, that conclusion required a proper step transaction analysis, which the court failed to undertake.

When this Court recently applied an interdependent steps analysis in *Commissioner v. Clark*, 489 U.S. 726 (1989), it made clear that mere transitory steps are properly ignored and "interrelated yet formally distinct steps in an integrated transaction may not be considered independently of the overall transaction." *Clark*, 489 U.S. at 738. Plainly, with respect to petitioner, the Marina Pacifica transactions present a full circle of interdependence.[14]

There were two reasons for making the redemption of Lansdale's Marina Pacifica partnership interest interdependent with the partnership's sale of the Long Beach realty. First, that assured the partnership that once the realty was purchased, Lansdale, as a partner, could not claim an interest in the sales proceeds. Second, that assured the purchaser of the realty that once the property was acquired, the only claim Lansdale could make to it was through his interest in Pacifica Properties, a new

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[14] The contract rights assigned to petitioner were interdependent with the sale already negotiated because: (1) the acquisition of the Long Beach property depended on the withdrawal of petitioner's sole shareholder, William Lansdale, from the Marina Pacifica partnership; (2) Landsdale's withdrawal from the Marina Pacifica partnership depended on the acquisition of the Long Beach realty, the distribution to him of certain partnership assets and the redemption of petitioner's newly acquired Pacifica Properties limited partnership interest for cash, notes and oil properties; (3) petitioner's contribution to Pacifica Properties was conditioned on the simultaneous redemption of its interest for cash, notes and oil properties; and (4) the redemption of petitioner's Pacifica Properties limited partnership interest depended on the acquisition of the Long Beach realty, and the buyer's contribution to the limited partnership of cash, notes and oil properties for distribution to petitioner.

limited partnership controlled by the purchaser. Since Lansdale had only an indirect interest in the Long Beach realty as a limited partner in Marina Pacifica, the assignment of that limited partnership interest to a newly formed limited partnership with a simultaneous redemption of 23/24's of the new limited partnership interest (in exchange for cash, notes and oil properties to be contributed by the purchaser) was simply a means for Lansdale to be compensated for his "share" of the Long Beach property.

There was absolutely no need to form petitioner to accomplish this transaction. Petitioner was created and inserted into the transaction—by having it serve as the assignee and assignor of Lansdale's Marina Pacifica partnership interest—only to take advantage of the perceived tax benefit that would be available to it as a United States corporation inhabitant in the Virgin Islands.

Petitioner's income tax returns filed with respondent reported income attributable to the Marina Pacifica transactions as nontaxable foreign (i.e., United States) source income. However, under the assignment of income doctrine and long established precedents of this Court, petitioner is not properly liable for tax with respect to that income. Specifically, where, for tax purposes, an individual would transform his own sale into a sale by another person or entity, *Commissioner v. Court Holding Co.*, 324 U.S. 331, 334 (1945), stands for the proposition that the use of the transferee as a conduit through which to pass title will be disregarded as an impermissible assignment of income. This fundamental income tax principle has long been recognized. *See Waltham Netoco Theatres, Inc. v. Commissioner*, 401 F.2d 333, 335 (1st Cir. 1968); *Hines v. United States*, 477 F.2d 1063, 1069-1070 (5th Cir. 1973). For petitioner to be taxed on the 1981 proceeds requires a finding that it participated, in some meaningful way, in the sales negotiations. *Id.; see also, Murry v. Commissioner*, T.C. Memo 1984-670, 49

T.C.M. (C.C.H.) 403, 409 (1984), *Baumer v. United States*, 580 F.2d 863, 870 (5th Cir. 1978).[15]

The District Court's underinclusive analysis of the assignment of income issue was analytically deficient because it failed to consider the application of the doctrine in the context of a sale of property. The memorandum decision does not even cite *Commissioner v. Court Holding Co.*, even though both petitioner and respondent discussed that case extensively in the briefs. This failure to consider the assignment of income doctrine in the proper situational context erroneously led the district court to conclude that the doctrine does not apply here.

Respondent's deficiency notices of May 13, 1986 and October 13, 1987 determined tax liabilities based, in part, on characterizing the gain reported by petitioner attributable to the Marina Pacifica transactions as ordinary income. To support those deficiency determinations respondents contended that the transactions should be recharacterized as a disguised sale by petitioner. Record, at p. 220A. The district court adopted that recharacterization by confirming respondents' deficiency determination.[16] *See* p. 9a, *infra*. However, having opened the re-

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[15] Under *Court Holding Co.* principles, the relevant analytic issues are (1) who negotiated the sale; i.e., whether the taxpayer sought to be held liable for gain or loss, or someone else; (2) whether the taxpayer performed any substantive role in the transaction, and if so, the significance of that role, and (3) whether, as a practical matter, the transaction was completed before the taxpayer was inserted into the transaction. *Court Holding Co.*, 324 U.S. at 333-334. Here, petitioner did not negotiate or participate in negotiations for the sale of the Long Beach property. Nor did petitioner have any substantive role in the transaction. Finally, the stipulated facts make plain that the economic substance of the Parcel 1-B transaction was completed long before petitioner was even contemplated. *See*, p. 22a-33a; 37a-38a, *infra*.

[16] The district court's confirmation of the dollar amount deficiencies, based on treating the gain as ordinary income, requires findings that (1) the transferred interest constituted trade or business property and (2) petitioner was in the business of selling such

characterization door, respondents and the district court have seized upon only one aspect of the transaction, petitioner's purported "disguised sale" of distribution rights. This, of course, ignores the interdependent steps of the transaction. *See Associated Wholesale Grocers, Inc. v. United States*, 927 F.2d 1517, 1523 (10th Cir. 1991); *Kuper v. Commissioner*, 533 F.2d 152, 156 (5th Cir. 1976). Once respondents attack one aspect of the transaction as a disguised sale, it is necessary to review all interdependent steps of the transaction to determine the economic substance of the transaction as a whole. *Clark*, 489 U.S. 726, 738.

Respondents' argument that petitioner may not disavow the reported form of its transaction is beside the point because it is respondents that seek to recharacterize the transaction as a disguised sale. When the government seeks recharacterization, it must choose the correct recharacterization, not the one that simply produces the greatest amount of tax. The taxpayer should have every right to assert the step transaction doctrine in defense to the government's recharacterization challenge. *See* Robert Thornton Smith, "Substance and Form: A taxpayer's Right to Assert the Priority of Substance," 44 *Tax Lawyer* 137, 172-173 (Fall 1990). Indeed "it would be an abuse of the function of the substance over form principle to selectively or incompletely apply it (in order to maximize tax revenue), and in the name of substance subject a taxpayer to tax on other than the transactional substance." *Id.* at 173.

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property in the ordinary course. I.R.C. §§ 1221(a), (2) and 1231 (b)(1) (1986). However, the district court made no findings whatsoever in this regard. No facts of record establish that the transferred interest would be anything other than a capital asset in petitioner's hands. The only inference that can reasonably be drawn from the stipulated facts is that petitioner was *not* in the business of selling such property, in which case the transferred interest would have been just as much a capital asset in petitioner's hands as in the hands of its sole shareholder.

CONCLUSION

For these various reasons, this petition for certiorari should be granted. Leaving undisturbed the decisions below would undermine this Court's effort in *United States v. Boyle*, 469 U.S. at 248, to fashion a "bright line" with respect to the circumstances where a taxpayer's reliance on the advice of counsel precludes a finding of negligence. The decisions also usurp the proper authority of Congress (1) by judicially authorizing the Virgin Islands to collect tax revenues that would rightfully belong only to the United States, and (2) by extending United States procedural and administrative tax law to the Virgin Islands.

Respectfully submitted,

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May 13, 1992

APPENDIX

APPENDIX

UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

No. 91-3202

LA ISLA VIRGEN, INC.

v.

ANTHONY P. OLIVE, DIRECTOR VIRGIN ISLANDS
BUREAU OF INTERNAL REVENUE

(D.C. Civil No. 86-263)

LA ISLA VIRGEN, INC.

v.

ANTHONY P. OLIVE, DIRECTOR VIRGIN ISLANDS
BUREAU OF INTERNAL REVENUE
GOVERNMENT OF THE VIRGIN ISLANDS

(D.C. Civil No. 88-12)

LA ISLA VIRGEN, INC.

v.

ANTHONY OLIVE, DIRECTOR VIRGIN ISLANDS
BUREAU OF INTERNAL REVENUE,
GOVERNMENT OF THE VIRGIN ISLANDS
OF THE UNITED STATES

(D.C. Civil No. 88-270)

LA ISLA VIRGEN, INC.,

Appellant

On Appeal from the District of the Virgin Islands
(D.C. Civil Action Nos. 86-00263, 88-00012, 88-00270)
District Judge: Honorable James T. Giles

Argued December 2, 1991

BEFORE: STAPLETON, HUTCHINSON, and NYGAARD, *Circuit Judges*

JUDGMENT ORDER

After consideration of the contentions raised by appellant, it is

ORDERED AND ADJUDGED that the judgment of the district court be and is hereby affirmed.

Costs taxed against appellant.

By the Court,

/s/ Walter K. Stapleton
Circuit Judge

ATTEST:

/s/ Sally Mrvos
SALLY MRVOS
Clerk

Dated: Dec. 17, 1991

IN THE DISTRICT COURT
OF THE VIRGIN ISLANDS
DIVISION OF ST. THOMAS AND ST. JOHN

Civil Nos. 86-263, 88-12 and 88-270

LA ISLA VIRGEN, INC.,
Petitioner,

v.

ANTHONY P. OLIVE, DIRECTOR VIRGIN ISLANDS
BUREAU OF INTERNAL REVENUE,
Respondent.

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MEMORANDUM

GILES, J.

La Isla Virgen ("LIV") filed petitions for redetermination of income tax liability for income earned in the continental United States in tax years 1982 through 1986. Defendant, Virgin Islands Bureau of Internal Revenue ("VIBIR") served the notice of deficiency on

LIV under the Tax Reform Act of 1986, § 1277(c)(E). The court now considers cross-motions for summary judgment. The parties have entered into extensive stipulations of fact which are incorporated herein by reference as Stipulation Dated October 25, 1990.

BACKGROUND

LIV is an "inhabitant" of the Virgin Islands within the meaning of § 28(2) of the Revised Organic Act, 48 U.S.C. § 1642 and has been for the entire period relevant to this action. The VIBIR issued three (3) separate notices of deficiency to LIV for tax liability on extra-territorial income LIV earned in 1982, 1983, 1984, 1985 and 1986.

William and Maranthi Landsdale own 100% of the stock of LIV, which was incorporated in March, 1981. Since that date William Lansdale ("Lansdale") has been its director. In 1988 LIV merged with Marina Pacifica Oil Co. ("Marina"). The Lansdales are the shareholders and directors of Marina.

LIV filed timely income tax returns with the VIBIR for fiscal years 1982 and 1983 using form 1120F, the U.S. Income Tax Return for foreign corporations.

The 1982 return reported as non-taxable foreign source income in the amount of $7,884,093 of which $6,972,045.61 was attributed to the redemption of 95.833% of a 24% limited partnership interest in Pacifica Properties.

Similarly, the 1983 return reported foreign source income in the amount of $1,308,688 attributed to proceeds from dispositions of the same partnership interest. In October of 1984 LIV was late in filing its 1120F return. That return reported as foreign source income $7,909,385 which included LIV's redemption of a remaining 1% interest in Pacifica Properties and the sale of certain oil and gas properties to Marina. (See Stipulation Dated October 25, 1990 at Paras. 1-9).

The questions now presented by the parties' cross-motions for summary judgment are: 1) whether § 1277 (c)(2)(E) of the Tax Return Act of 1986 bars the VIBIR from assessing income tax liability against LIV for transactions enumerated in subsection (E)(ii); 2) whether LIV's redemption and disposition of limited partnership interests in 1981 and 1983 are properly characterized as a sale by LIV; and 3) whether LIV is liable for tax penalties under sections 6653, 6661 and 6651. Summary judgment is appropriate as there are no material issues of fact in dispute.

Marina Pacifica is a 40 acre tract of property located in Long Beach, California on which Lansdale purchased a long term lease in 1959. In 1972 Southern California Financial Corp. ("SCFC") formed Marina Pacifica Ltd. Partnership ("MPLP"), and became the General Manager of MPLP. Lansdale was one of three (3) limited partners. They formed MPLP for the purpose of developing and managing the property. However, by 1980 Lansdale was the only remaining limited partner of MPLP. SCFC continued as the general partner. Lansdale formed LIV on March 6, 1981 and on March 11, 1981 effectively transferred to LIV all his property and capital contribution of distribution interests in Marina Pacifica. See, Stipulation ¶ 34. On March 12, 1981 SCFC through MPLP sold 38 of the 40 acres tract of Marina Pacifica to Pacifica Properties a limited partnership formed on the same day, March 12, 1981 by LIV and Robert Langslet for the purpose of buying the tract in question.

LEGAL ANALYSIS

As a domestic corporation of the United States and an "inhabitant" of the Virgin Islands, defendant must pay its total tax liability into the Virgin Islands treasury without regard to where its taxable income was earned. *Danbury, Inc. v. Olive*, 820 F.2d 618, 622 (3d Cir.), *cert. denied*, 484 U.S. 964 (1987).

LIV argues that § 1277(c)(2)(E) of the Tax Reform Act of 1986 provided it with an exception from repeal of the tax loophole of 26 U.S.C. § 7651. In order to understand this argument one must know the history of the Virgin Islands tax laws.

In 1921 Congress enacted the Naval Appropriations Act, which provided that the income tax laws of the United States also constitute the income tax laws of the Virgin Islands with proceeds therefrom paid into the Virgin Islands treasury. *See* 48 U.S.C. § 1397. This created what became known as the "mirror tax" system of the Virgin Islands. The effect of this system was that some taxpayers had to file two returns, one to the Internal Revenue Service ("IRS") and one to the VIBIR. A United States corporation doing business in the Virgin Islands had to file a return with the IRS declaring stateside earnings and one with the Virgin Islands declaring Virgin Islands earnings. *Bizcap, Inc. v. Olive*, 892 F.2d 1163, 1165 (3d Cir. 1989).

However, this dual return system appeared simplified by the Revised Organic Act of 1954, 48 U.S.C. § 1642, which states that

> "inhabitants" of the Virgin Islands "shall be covered into the treasury of the Virgin Islands . . . Provided that the terms inhabitants of the Virgin Islands' . . . shall include all persons whose permanent residence is in the Virgin Islands and such persons shall satisfy their income tax obligations under applicable statutes of the United States by paying their tax on income derived from *all* sources both within and outside the Virgin Islands into the treasury of the Virgin Islands."

However, thereafter Congress enacted 26 U.S.C. § 7651(5)(B), which provides, in pertinent part:

> "For the purpose of this title . . . Section 28(a) of the Revised Organic Act of the Virgin Islands shall

be effective as if such section had been enacted subsequent to the enactment of this title."

In 1986 *Danbury v. Olive*, 627 F. Supp. 513 (D.V.I. 1986) the federal district court erroneously ruled that an inhabitant corporation incorporated in the United States need only pay taxes due on Virgin Islands receipts so that stateside income was exempt from reporting in the Virgin Islands. In response to this opinion, Congress enacted 26 U.S.C. § 7651(5)(B) to clarify tax treatment of income earned by Virgin Islands inhabitants. This returned the tax system to a dual return filing system. However, the enactment was not retroactive.

Section 1277(c)(2) of the Act provides that this amendment applies to any taxable year beginning after December 31, 1986 and any pre-1987 open year. A pre-1987 open year is any year before January 1, 1987 if on the date of the enactment of the Act the assessment of a deficiency of income tax for the year or years is not barred by any law. *Bizcap*, 892 F.2d at 1165, *citing* the Tax Reform of 1986, Pub. L. No. 99-514, Title XII, § 1277(c)(2). The third circuit reversed the lower court decision in *Danbury* and determined that VIBIR could assess deficiencies if the years in question were pre-1987 open years. *Id.*

LIV argues that this court should not follow *Bizcap* and that it is not applicable because it addresses § 1271(c)(2)(D), not § 1271(c)(2)(E). Subsection (E) lists income to which § 7651 does not apply retroactively.

Defendant does not dispute that LIV is the corporation described in this subsection. LIV and Bizcap lobbied for this exception to the non-retroactive application of § 7651. However, as previously stated, the third circuit has already determined in *Bizcap* that although Bizcap gained an exemption from IRS tax liability by the retroactivity exception it was not granted an exemption from Virgin Islands tax liability as it existed prior to the enactment of § 7651. *Id.* at 1167. Prior thereto, a U.S. corporation

inhabiting the Virgin Islands filed one return paying *all* its tax liability to the Virgin Islands. In other words, the form of payment may have been different, but not the amount of the payment.

In essence, LIV now makes the same argument that Bizcap made and which the third circuit has already rejected. LIV contends that Congress intended to provide it complete exemption from tax liability on transactions specified in § 1277(c)(2)(E). It argues that subsection (E)(iii) provides language which makes clear the intent of Congress to exempt it from *all* tax liability. It provides:

> "LIMITATION . . . The aggregate reduction in tax by reason of this subparagraph shall not exceed $8,312,000. If the taxes which would be payable as the result of the application of the amendment made by section 1275(b) to pre-1987 open years exceeds the limitation of the preceding sentence, such excess shall be treated as attributable to income received in taxable years in reverse chronological order."

This subsection must be read in a manner consistent with the statutory scheme. The third circuit has stated that no tax loophole *ever* existed to protect stateside income earned by inhabitants of the Virgin Islands. "[T]he drafters of the legislation could have specifically stated that the targeted corporations were exempt from tax liability on stateside income for the years in question" but did not. *Bizcap*, 892 F.2d at 1167. Therefore, this court is bound by, and follows, the third circuit's statutory interpretation and concludes in this instance that Congress never specifically stated that LIV was exempt from tax liability, although it could had it chosen to do so. Therefore, VIBIR's cross-summary judgment motion must be granted on this issue.

The remaining issues are whether the assignment of income doctrine is applicable to LIV's 1981 and 1983 transactions and whether tax penalties are appropriately assessed.

The parties stipulated to many transactions to aid the Court, ostensibly, in characterizing the transaction. Succintly stated, if LIV acted as Lansdale's assignee, then LIV would not be liable for the gain received on the sale on the assignment of income doctrine. However, if the transaction is construed as a sale by LIV, its gain from the transaction is taxable.

The assignment of income doctrine provides that one who earns income may not escape taxation by assigning it to another. *Caruth Corp. v. U.S.*, 865 F.2d 644, 648 (5th Cir. 1989). If a taxpayer gives away earnings from an income producing asset, but retains the asest, the doctrine applies. *Id.* at 649. However, it is not applicable here.

It is uncontroverted that Lansdale transferred all his interest in the property to LIV on March 11, 1981 prior to sale of that property the next day by MPLP to Pacifica Properties. Since he transferred to LIV all his rights and interests in Marina Pacifica for legitimate tax reasons, he received no personal gain from the subsequent sale of the property.

The VIBIR assessed penalties under 26 U.S.C. §§ 6651 (a), 6653(a) and 6661(a). Section 6651(2) provides for penalties of 5% of the tax due for each month that the return is late, unless the failure to timely file is due to a reasonable cause. Penalties were assessed for tax years 1984, 1985 and 1986. LIV does not dispute that its returns were not timely filed. However, it argues that its returns were late for reasonable cause. It avers that it relied on its accountant to file the returns on time. The U.S. Supreme Court has ruled that a taxpayer's reliance on an agent to file its return on time does not constitute reasonable cause for § 6551(a) purposes. *U.S. v. Boyle*, 469 U.S. 241 (1984). Therefore, the penalties were properly assessed on taxes due on the 1984, 1985 and 1986 tax returns.

Additionally, LIV argues that the appropriate penalty statutes are found in the Virgin Islands Tax Code. How-

ever, it overlooks the fact that the Virgin Islands Tax Code applies to Virgin Islands taxes. The taxes upon which the VIBIR bases these penalties are due on stateside income. Therefore, the United States Tax Code provides the appropriate authority.

Section 6653(a) provides that the Commissioner may assess a penalty for negligent or intentional underreporting of taxable income. The taxpayer has the burden of proving the absence of negligence or intentional disregard of rules and regulations. *Business Ventures Int'l v. Olive*, 893 F.2d 641, 646 (3d Cir. 1990).

LIV's position is that it was not negligent because it relied on advice of its legal counsel in determining its tax liability. Negligence is measured by the reasonable, prudent person standard. *Sammons v. Commissioner*, 838 F.2d 330 (5th Cir. 1988). However, if its legal counsel was negligent, LIV would be liable under this section. There is no showing that LIV's counsel was other than negligent.

Intentional disregard occurs when a taxpayer knows or should know of a rule or regulation [but] chooses to ignore its requirements. *Marello v. Comm'ner*, 380 F.2d 499, 506 (5th Cir. 1967), *cert. denied* 389 U.S. 1044 (1968). Unsophisticated taxpayers who act in good faith should not be assessed penalties. *Haman v. Comm'ner*, 500 F.2d 401 (9th Cir. 1974). This record does not support a finding of intentional disregard of the tax rules or regulations. Under § 6661 the Commissioner may assess penalties for understatement of tax liabilities. It is uncontroverted that LIV and the transaction it structured were tax shelter schemes. Therefore, LIV can only avoid penalty under § 6661(b)(2)(c)(ii), if it had "substantial authority" for its position on its liability. LIV did not have such authority for the position that it owed no tax on stateside income. Therefore, penalties assessed under this provision were proper.

An appropriate order follows.

DATED: February 28, 1991

IN THE DISTRICT COURT
OF THE VIRGIN ISLANDS
DIVISION OF ST. THOMAS AND ST. JOHN

Civil Nos. 86-263, 88-12 and 88-270

LA ISLA VIRGEN, INC.,
Petitioner,

v.

ANTHONY P. OLIVE, DIRECTOR VIRGIN ISLANDS
BUREAU OF INTERNAL REVENUE,
Respondent.

ORDER

AND NOW, this 28th day of February, 1991, upon consideration of the motion for summary judgment of La Isla Virgen, Inc. ("LIV") and the cross-motion for summary judgment of the Virgin Islands Bureau of Internal Revenue ("VIBIR"), it is hereby ORDERED that the cross-motion of VIBIR is GRANTED and the motion for summary judgment of LIV is DENIED, dismissing the complaint.

ENTER:

/s/ James T. Giles
JAMES T. GILES
United States District Judge
Sitting by Designation

ATTEST:

ORINN ARNOLD
Clerk of Court

By: /s/ Frank Blackman
Deputy Clerk

UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

No. 91-3202

LA ISLA VIRGEN, INC.

v.

ANTHONY P. OLIVE, DIRECTOR VIRGIN ISLANDS
BUREAU OF INTERNAL REVENUE

(D.C. Civil No. 86-263)

LA ISLA VIRGEN, INC.

v.

ANTHONY P. OLIVE, DIRECTOR VIRGIN ISLANDS
BUREAU OF INTERNAL REVENUE
GOVERNMENT OF THE VIRGIN ISLANDS

(D.C. Civil No. 88-12)

LA ISLA VIRGEN, INC.

v.

ANTHONY OLIVE, DIRECTOR VIRGIN ISLANDS
BUREAU OF INTERNAL REVENUE,
GOVERNMENT OF THE VIRGIN ISLANDS
OF THE UNITED STATES

(D.C. Civil No. 88-270)

LA ISLA VIRGEN, INC.,
Appellant

SUR PETITION FOR REHEARING

Before: SLOVITER, *Chief Judge*, BECKER, STAPLETON, MANSMANN, GREENBERG, HUTCHINSON, SCIRICA, COWEN, NYGAARD, ALITO, and ROTH, *Circuit Judges*

The petition for rehearing filed by appellant in the above-entitled case having been submitted to the judges who participated in the decision of this Court and to all the other available circuit judges of the circuit in regular active service, and no judge who concurred in the decision having asked for rehearing, and a majority of the circuit judges of the circuit in regular active service not having voted for rehearing by the court in banc, the petition for rehearing is denied.

By the Court,

/s/ Walter K. Stapleton
Circuit Judge

Dated: Jan. 14, 1992

SUPREME COURT OF THE UNITED STATES

No. A-709

LA ISLA VIRGEN, INC.,
Petitioner

v.

ANTHONY P. OLIVE, DIRECTOR OF VIRGINIA [*sic*]
BUREAU OF INTERNAL REVENUE, *et al.*

ORDER

UPON CONSIDERATION of the application of counsel for the petitioner,

IT IS ORDERED that the time for filing a petition for a writ of certiorari in the above-entitled case, be and the same is hereby, extended to and including May 13, 1992.

/s/ DH Souter
Associate Justice of the Supreme
Court of the United States

Dated this 25th day of March, 1992.

IN THE DISTRICT COURT
OF THE VIRGIN ISLANDS
DIVISION OF ST. THOMAS AND ST. JOHN

Civil Nos. 86-263, 88-12 and 88-270

LA ISLA VIRGEN, INC.,
Petitioner,

vs.

ANTHONY P. OLIVE, DIRECTOR
VIRGIN ISLANDS BUREAU OF INTERNAL REVENUE,
Respondent.

PETITIONS FOR REDETERMINATION OF
INCOME TAX LIABILITY

STIPULATION

It is hereby stipulated by the parties, for the purpose of this case only, that the following facts shall be accepted as true and that the exhibits hereinafter mentioned shall be considered authentic documents and may be admitted into evidence, subject to the right of either party to object to the admission of such facts and exhibits on the grounds of materiality or relevance and subject to the right of either party to introduce further evidence not inconsistent with the matters herein stipulated.

JURISDICTION

1. This Court has jurisdiction over this matter pursuant to 48 U.S.C. Section 1612.

2. This case involves the income tax liability of the Petitioner, La Isla Virgen, Inc., (hereinafter "LIV") for

five fiscal years. The Virgin Islands Bureau of Internal Revenue, (hereinafter "VIBIR") by Notices of Deficiency attached as Exhibits 1, 2, and 3, notified the petitioner that it has determined the following deficiencies:

FYE	TAX	PENALTY 6653(a)	PENALTY 6661 **	PENALTY 6651
2/28/82	3,609,398	180,470*		
2/28/83	582,161	29,108*	58,216	
2/29/84	3,618,536	180,927*	361,854	904,634
2/29/85	459,905	22,995*	45,990	114,976
2/29/86	459,927	22,996*	45,992	22,996

* Plus 50% of the interest due on the income tax deficiency.

** Respondent was granted leave to amend its answers, by Order dated April 12, 1990, to assert the increase of the Section 6661 penalty from 10% to 25%, as provided by Congress in Section 8008 of the Omnibus Budget Reconciliation Act of 1986, for penalties assessed after October 21, 1986.

3. The Petitioner was, at all times relevant to this proceeding, an "inhabitant" of the Virgin Islands pursuant to Section 28(a) of the Revised Organic Act of the Virgin Islands, 48 U.S.C. Section 1642. LIV timely filed its Petitions for Redetermination of Income Tax Liability in response to the three statutory notices of deficiency referred to in stipulation #2, which were consolidated by Order of this Court dated April 12, 1990.

4. The Respondent is the Virgin Islands Bureau of Internal Revenue, Government of the Virgin Islands, Anthony P. Olive, Director.

STATEMENT OF ISSUES

5. The issues before the Court are the following:

(i) Whether Section 1277(c)(2)(E) of the Tax Reform Act of 1986 (hereinafter "TRA 1986") bars the VIBIR from assessing an income tax liability with respect to income derived from the transactions described in Section 1277(c)(2)(E)(ii), as contended by LIV.

(ii) Whether the redemptions of limited partnership interests of LIV and subsequent disposition of the proceeds in 1981 and 1983 are properly characterized for income tax purposes as sales by LIV's shareholders as contended by LIV, or properly characterized as a sale by LIV, as contended by VIBIR.

(iii) If the Court concludes LIV is properly treated for tax purposes as the seller on the 1981 and 1983 transactions, whether the income derived from such transactions was entitled to capital gains treatment under Internal Revenue Code (hereinafter IRC) Section 1221 or 1231, as contended by LIV, or taxable as ordinary income as contended by VIBIR.

(iv) Whether LIV was entitled to use the installment method of reporting income from the sale of certain oil and gas properties in 1983, as contended by LIV, or whether LIV had effectively elected out of the installment sale method pursuant to IRC section 453(d) as contended by VIBIR.

(v) Whether LIV is liable for penalties under IRC sections 6653, 6661 and 6651 as set forth in the VIBIR statutory notices of deficiency.

STIPULATIONS

6. LIV was incorporated in Delaware on March 6, 1981, and qualified to do business in the Virgin Islands on June 1, 1981. (See Exhibits 4 and 5.) William M. and Marianthi Lansdale, husband and wife who are residents of California, have at all times relevant to this proceeding owned 100% of the stock of LIV. Mr. William M. Lansdale has been a Director of LIV continuously from its incorporation in March 1981, until its statutory merger into Marina Pacifica Oil Company in November 1988. Mr. William Lansdale was President of LIV, at the time of the merger. William M. and Marianthi Lansdale are shareholders, officers and directors of the sur-

viving corporation which is called Marina Pacifica Oil Company.

7. The other officers and directors of LIV during the periods in issue were Gustav A. Danielson, President and Director from March 1981 to September 15, 1981; John Foster, President and Director, September 15, 1981 through February 1986; Rex Danielson, Secretary, Treasurer and Director, from March 1981 through February 1986; and Beverly White, Assistant Secretary and Treasurer from March 1981 through February 1983.

8. LIV timely filed its income tax returns (Forms 1120F, U.S. Income Tax Return of a Foreign Corporation) for the fiscal years ended 2/28/82 and 2/28/83 with the Virgin Islands Bureau of Internal Revenue. The return for the fiscal year ended 2/28/82, Schedule M-1, Line 7 reports foreign source income recorded on LIV's books but not included in taxable income in the amount of $7,884,093, of which amount approximately $6,972,045.61 is attributable to the redemption of 95.833% of a 24% limited partnership interest in Pacifica Properties. The return for the fiscal year ended 2/28/83, Schedule M-1, Line 7, similarly reports foreign source income of $1,308,688 attributable to the proceeds from such dispositions of property. See Exhibits 6 and 7.

9. LIV failed to timely file its income tax return (Form 1120F, U.S. Income Tax Return of a Foreign Corporation) for the fiscal year ended 2/29/84 with the Virgin Islands Bureau of Internal Revenue. That return was filed on October 24, 1984. This Form 1120F reported foreign or non-V.I. source income recorded on LIV's books of $7,909,385. on Line 7 of Schedule M-1 which included the redemption of LIV's remaining 1% interest in Pacifica Properties and the sale of certain oil and gas properties to Marina Pacifica Oil Company. See Exhibit 8.

10. LIV failed to timely file its income tax returns (Forms 1120F, U.S. Income Tax Return of a Foreign

Corporation) for the fiscal years ended 2/29/85 and 2/29/86 with the Virgin Islands Bureau of Internal Revenue. These returns were filed on October 11, 1985, and June 9, 1987, respectively. Foreign or non-V.I. source income recorded on LIV's books of $1,431,849. and $1,439,385. was reported on Line 7, Schedule M-1, of Forms 1120F for these years. See Exhibits 9 and 10.

11. LIV timely filed Reports of Corporation Franchise Tax Due, pursuant to Title 13, Section 531, of the Virgin Islands Code and LIV timely filed Annual Reports pursuant to Title 13, Section 373 of the Virgin Islands Code with the Office of the Lieutenant Governor showing book income consistent with the book income reported on the Forms 1120F filed with the VIBIR for the fiscal years at issue. See Exhibits 11, 12, 13, 14, and 15.

OPERATIVE FACTS—THE DISPOSITION OF THE LIMITED PARTNERSHIP INTEREST IN 1-B MARINA PACIFICA

12. Marina Pacifica is a parcel of real property of approximately 40 (forty) acres located in Long Beach, California. Mr. William Lansdale purchased a long term lease on this parcel in 1959. Marina Pacifica is also the name of a limited partnership (hereinafter "Marina Pacifica Limited Partnership") formed in California in 1972 by Southern California Financial Corp., the general partner, (hereinafter "SCFC"), and Mr. William Lansdale and two other individuals, the limited partners, for the purpose of developing the Marina Pacifica (Long Beach) property. (Lansdale deposition pgs. 18-23.) The development of the Marina Pacifica property was divided into three phases, identified as 1-A, 1-B and 1-C. Phases 1-A and 1-C of the development of Marina Pacifica are not involved in these consolidated cases. Civ. No. 86-263 involves the disposition of Phase 1-B of Marina Pacifica.

13. Phase 1-B was a piece of property adjoining the other parcels, 1-A and C, by a waterway, and was com-

prised of approximately 38 net acres of R-1 zoned property. (Lansdale deposition page 27).

14. By 1980 and at the time of the disposition of Phase 1-B in March 1981, the remaining relevant partners of the Marina Pacifica Limited Partnership were SCFC, the general partner, and Mr. William Lansdale, a limited partner.

—15. In 1980 Marina Pacifica Limited Partnership decided to sell Phase 1-B of the Marine Pacifica property rather than develop it. (Lansdale deposition page 28.) The general partner, SCFC, generated nine written offers for the property which were discussed with Mr. William Lansdale, the limited partner, in November 1980. (Lansdale deposition pages 29-30.) On December 3, 1980, SCFC informed Mr. Lansdale that the partnership and SCFC were not in a position to provide or obtain funds or credit necessary to proceed with the Marina Pacifica project. SCFC also informed Lansdale that they were prepared to proceed with a sale of Phase 1-B to The Robert P. Warmington Company for $40 million and requested his approval. See Exhibit 16-Letter dated 3 December 1980 from Frank R. Moothart, President SCFC, to Mr. William Lansdale. Mr. Lansdale did not approve the Warmington offer.

16. During 1980 Mr. Lansdale had also negotiated directly with a potential purchaser, Showcase Homes, (Exhibit 17) and, the ultimate purchaser, C. Robert Langslet & Son, Inc. (Exhibit 18). Mr. Langslet approached Mr. Lansdale expressing an interest in the Marina Pacifica 1-B property and Mr. Lansdale in October 1980 referred him to the general partner, SCFC, to begin negotiations. (Lansdale deposition page 32). On December 8, 1980, Mr. Lansdale informed SCFC that he intended to present the general partner an offer identical to Warmington's offer which he, William Lansdale, would be prepared to approve. See Exhibit 19. In anticipation of a meeting between Mr. Lansdale and SCFC, Rufus v. Rhoades, Esq.,

Mr. Lansdale's attorney advised Mr. Lansdale to tell SCFC that in this alternative proposal he (Mr. Lansdale) would be "staying in as a partner as it now appears". See December 10, 1980 letter from Rufus v. Rhoades to Mr. William Lansdale, Exhibit 20.

17. On or about December 15-16, 1980 Mr. Lansdale and Frank R. Moothart, president of SCFC, met with Mr. Langslet to discuss the sale of the Marina Pacifica 1-B property and certain other assets of Marina Pacifica Limited Partnership to Mr. Langslet. Also present at that meeting was Mr. Rhoades. (Rhoades deposition (June 22, 1990, pgs. 14-15, 18; Rhoades deposition (June 25, 1990), pgs. 4-5). At the meeting Messrs. Lansdale, Moothart and Langslet reached agreement with respect to a transaction as described in the correspondence at Exhibits 18, 21, 24, and 25. (See Rhoades deposition (June 22, 1990, pgs. 6, 15-16) and Rhoades deposition (June 25, 1990), pg. 7).) Rufus v. Rhoades' notes from this meeting are attached as Exhibit 26.

18. Lansdale, by letter dated December 16, 1980 to Mr. Langslet summarized the terms of the agrement between himself and Mr. Langslet for the acquisition of Mr. Lansdale's limited partnership interest in Marina Pacifica as part of Mr. Langslet's acquisition of the 1-B property. (Exhibit 18).

19. By letter dated 16 December 1980, SCFC agreed to postpone the execution of the proposed transaction with The Warmington Company to give Mr. Lansdale another opportunity to buy the partnership assets. SCFC agreed to favorably consider an offer from Lansdale that was "at least as good in all respects as the offer from The Robert P. Warmington Company as guaranteed by New England Mutual Life Insurance Company." See Exhibit 21.

20. From December 15, 1980, until closing on March 27, 1981 attorneys representing SCFC, William Lansdale and C. Robert Langslet & Son, Inc. (hereinafter "Langslet") proceeded to prepare, revise and refine docu-

ments, for the acquisition of Marina Pacifica Phase 1-B by Langslet. See Exhibits 22 and 23.

21. Crocker National Bank agreed to finance the Langslet acquisition subject to review and approval of title, leases, plans, specifications, engineering and geological reports and an appraisal. See letter dated December 15, 1980, Exhibit 24.

22. SCFC, by letter dated 18 December 1980, notified Langslet that it would consummate the sale of Marina Pacifica assets "substantially in accordance with your letter of 16 December and our oral discussions which took place at Marina Pacifica on 16 December" subject to: (a) a definitive agreement executed by all parties, and (b) receipt of Crocker Bank's unconditional, irrevocable guarantee of Langslet's $32.5 million note. See Exhibit 25. The letter does not specify a closing date but states that escrow is anticipated to close on or before February 28, 1981 and provides that interest would accrue on the $37,500,000 purchase price at a rate of 10 percent per annum from December 19, 1980 and continue thereafter until the closing.

23. Based on the foregoing, counsel for SCFC and Mr. Lansdale proceeded to draft an Agreement for Withdrawal, Settlement and Distribution by and among Marina Pacifica Limited Partnership, SCFC and William Lansdale. See Letter from Mr. Rhoades to Dennis D. Hill, Esq. dated December 22, 1980, Exhibit 27.

24. At the same time counsel for the various parties commenced preparation of a purchase and sale agreement which was entitled "Agreement for Purchase and Sale and Escrow Instructions" by and between Marina Pacifica Limited Partnership and Langslet. See letter from Robert E. Duffy, Esq. to Mr. William Lansdale dated January 29, 1981, Exhibit 28.

25. On January 15, 1981, William and Marianthi Lansdale executed a joint and several power of attorney in favor of Mr. Rhoades authorizing him:

To execute any and all agreements, papers, notices, claims, instructions, checks or other documents relating to or in any manner connected with

(a) our interest in a partnership formed by C. Robert Langslet & Son, Inc. as general partner and William M. Lansdale (acting for both of us) as limited partner, which partnership we have called "Pacifica Properties";

(b) our interest in Marina Pacifica, a California limited partnership of which William M. Lansdale is a named limited partner and any assets thereof in which we have an interest. (See Exhibit 29)

Mr. Rhoades' authority thereunder was limited by the express terms of that power of attorney, which (1) identifies specific Marina Pacifica Limited Partnership assets to be included among the properties distributed to the Lansdales and (2) requires that in the case of any agreements or documents relating to the transactions with Langslet said materials reflect the terms of the letter agreement of December 16, 1980 (Exhibit 18) between Lansdale and Langslet.

26. The power of attorney was sent to Mr. Rhoades with a transmittal letter signed by Mr. and Mrs. Lansdale (Exhibit 30). The transmittal letter instructs Mr. Rhoades on the use of the power and specifies the limits on the power of attorney.

27. Mr. Rhoades has stated under oath that:

> The power was given to me originally in the event that the closing accelerated and occurred while Mr. and Mrs. Lansdale were out of the country. It did not. They returned, and so we canceled the power of attorney so that there would be no question, that I do not any longer have their right to sign their name in the documents relating to Langslet transaction. (Rhoades deposition, June 25, 1990, pg. 41).

28. In early 1981, Mr. Lansdale was told by his accountant that there was a wrinkle in the tax law that

allowed U.S. corporations to get involved in the Virgin Islands and end up with certain tax advantages not normally available to U.S. corporations. (See page 20 of Rufus v. Rhoades June 22, 1990 deposition.)

29. Mr. Lansdale engaged Mr. Gustav Danielson, Esq., in coordination with Mr. Rufus v. Rhoades, Esq., to create La Isla Virgen (LIV) to take advantage of the perceived "wrinkle in the tax law." (See page 23 of Rufus v. Rhoades June 22, 1990 deposition.)

30. During the period prior to and immediately following the incorporation of LIV, Langslet and SCFC were continuing to work on Langslet's technical investigation and other aspects of the project, drafting required legal documents, and concluding financing arrangements. See letter dated February 18, 1981, from Langslet to SCFC, at Exhibit 35.

31. On February 24, 1981, Crocker National Bank advised Mr. William Lansdale that the Bank had approved the Langslet financing subject to five conditions. See letter dated February 24, 1981, at Exhibit 36.

32. On March 6, 1981, LIV was incorportaed in Delaware. The Certificate of Incorporation provides that "[t]he corporation's principal office and residence for the conduct of its affairs shall be loctaed in the United States Virgin Islands." Gustav A. Danielson, Esq., a resident of the Virgin Islands, was named as the sole director. Shareholder meetings were to be held only in the Virgin Islands. (See Exhibit 4.)

33. By letter dated March 11, 1981, to SCFC, Langslet reiterated their readiness to complete the purchase of Marina Pacifica 1-B subject to five outstanding items to be resolved. See Exhibit 37.

34. On March 11, 1981, the first meeting of the Board of Directors of LIV took place. The actions taken at that meeting are stated in the Minutes of the First Meeting of the Board of Directors at Exhibit 31. The following resolutions were unanimously adopted:

RESOLVED, that the corporation does hereby accept from William Lansdale the capital contribution of distribution interests in Marina Pacifica and all rights under a letter agreement dated December 6, [sic 16] 1980 with Robert Langslet & Son, Inc., (pertaining to formation of a Limited Partnership to be known as Pacifica Properties) as represented in assignments attached hereto and made a part hereof.

FURTHER RESOLVED, that the officers and directors are hereby authorized and directed to assign the distribution rights in Marina Pacifica to Pacifica Properties in exchange for a 24% limited partnership interest in that limited partnership as represented by assignments and partnership agreements attached hereto and made a part hereof.

FURTHER RESOLVED, that the officers and directors are hereby authorized and directed to subsequently redeem 23% [sic 95.833%] of its 24% interest in Pacifica Properties under the terms of the agreement attached hereto and made a part hereof.

FURTHER RESOLVED, that the officers, directors and agents of the corporation are hereby authorized and directed to do all things necessary and execute all documents with respect to the acceptance of the capital contribution, the assignment of property to Pacifica Marina [sic Properties] in exchange for partnership interest, the entering into a partnership agreement with Pacifica Marina [sic Properties] and the subsequent redemption of said partnership interest in whole or in part.

See Notice of Assignment and Assignment of Interest to LIV (of rights to receive distributions related to parcel 1-B) by William M. Lansdale, to Marina Pacifica Limited Partnership, dated March 11, 1981, at Exhibit 32.

See Assignment of Interest (of rights to receive distributions related to parcel 1-B) by LIV as a capital contribution to Pacifica Properties, a California limited partnership, at Exhibit 33.

35. On March 12, 1981, LIV and Langslet formed Pacifica Properties, a California Limited Partnership, as authorized by LIV's directors in stipulation No. 34 above, for the principal purpose of acquiring the property generally known as Marina Pacifica 1-B. LIV, the limited partner, contributed its expected distribution of Phase 1-B from Marina Pacifica Limited Partnership, (as previously assigned to LIV by Lansdale) and Langslet, the general partner, contributed its expected interest in the property to Pacifica Properties. The terms and conditions of this partnership agreement are contained in the Certificate of Agreement of Limited Partnership at Exhibit 38.

36. LIV, Langslet and Pacifica Properties immediately thereafter entered into the Agreement Regarding Acquisition of Partnership Interest, dated March 12, 1981, at Exhibit 39. By this agreement, Langslet agreed to contribute $3 million in cash, certain oil properties and the Marina Pacific 1-B properties, to Pacifica Properties, upon closing of the SCFC-Langslet agreement. The Agreement further provided that Pacifica Properties would redeem 23 of LIV's 24 percent interest in Pacifica Properties immediately after closing the SCFC transaction by distribution to LIV of the oil properties, the $3 million in cash, and promissory notes in the aggregate face amount of four million dollars ($4,000,000). The Agreement (at page 9) provides as follows:

> FURTHER ASSURANCE
>
> To induce La Isla Virgen, Inc. to enter into the foregoing Agreement, the undersigned covenants to acquire the interest of La Isla Virgen, Inc. in Marina Pacifica or the assets distributed to La Isla Virgen, Inc. by Marina Pacifica for the amounts indicated in paragraph 2 if, but only if, any corporation or entity in which the undersigned has an interest, directly or indirectly, acquires an interest in Marina Pacifica or any of its assets.
>
> C. Robert Langslet

37. On March 17, 1981, LIV gave Rufus v. Rhoades a power of attorney to execute documents on behalf of LIV to effect and implement the transactions discussed and approved by the board of directors at the meeting held March 11, 1981. See pages one and two of Exhibit 34.

38. On March 27, 1981, the following transactions, as evidenced in the referenced Exhibits, closed.

a). Langslet acquired SCFC's interest in the Phase 1-B Marina Pacifica property and certain other assets for Thirty-Seven Million Five Hundred Thousand Dollars ($37,500,000.00). The executed Agreement of Purchase and Sale and Escrow Instructions, by and between Marina Pacifica Limited Partnership, SCFC and Langslet, dated March 26, 1981, is attached as Exhibit 40.

b). As an express condition to the foregoing sale, William M. Lansdale retired and withdrew as a limited partner of Marina Pacifica. The terms and conditions which define Mr. Lansdale's rights, and his successive assignments of certain Phase 1-B distributions to LIV, in liquidation of his entire partnership interest, are set forth in the Agreement for Withdrawal, Settlement and Distribution entered into on March 27, 1981, by and among Marina Pacifica Limited Partnership, SCFC and William M. Lansdale, at Exhibit 41.

c). Langslet redeemed 23 of LIV's 24% (i.e., 95.833%) interest in Pacifica Properties (See Amendment No. 1 to Certificate of Limited Partnership dated March 27, 1981, at Exhibit 42) in exchange for $3,000,000 in cash and Promissory Notes Nos. 1 through 12 totalling $4,000,000.00 at Exhibit 43. Each promissory note states that it is secured by an irrevocable letter of credit issued by Crocker National Bank in favor of LIV.

d). Langslet assigned to LIV the oil and gas properties and any claims and causes of action related thereto by Quitclaim Deed, Bill of Sale and Assignment of Leases

and Assignment of Rights and Defenses, both dated March 27, 1981. See Exhibit 44.

e). LIV, Pacifica Properties and Langslet entered into Amendment No. 2 to Agreement Regarding Acquisition of Partnership Interest, wherein LIV acknowledged that Langslet and the partnership were merely serving as conduits for the transfer of title of the oil properties from Marina Pacifica to LIV. See Exhibits 45 and 46.

f). William M. and Marianthi Lansdale executed the Guaranty Agreement at Exhibit 47 wherein they unconditionally guaranteed the performance by LIV of all conditions to be performed by it under the Certificate of Limited Partnership as amended by Amendment Nos. 1 and 2.

g). Crocker National Bank advised LIV that a draft in the amount of $3,000,000.00 would be issued to LIV on Friday, March 27, 1981, subject to recordation of the Langslet loan. See Exhibit 48.

39. The purpose in creating LIV and contributing Lansdale's distribution rights with respect to the Marina Pacifica Phase 1-B and the oil properties to LIV was to minimize the income tax impact on income from the redemptions of the limited partnership interests, the subsequent dispositions of certain properties distributed in such redemptions, and income earned on proceeds from such transactions. LIV was structured to take advantage of the so called "28(a) Theory." See June 22, 1990, Rufus v. Rhoades deposition pages 22 and 23.

40. William M. and Marianthi Lansdale have not reported as taxable income any income or gain from the Marina Pacifica/Pacifica Properties transactions on their 1980 or 1981 Forms 1040 U.S. Individual Income Tax Returns. See also IRS Affidavit at Exhibit 49.

41. At all times from 1981 through 1986, the books and records of La Isla Virgen, Inc. (LIV) have reflected the

gains and proceeds from the Marina Pacifica/Pacifica Properties transactions as corporate income. See Exhibits 11 through 15. The Lansdales did not report these gains and proceeds on their Forms 1040 U.S. Individual Income Tax Returns.

42. Mr. Rhoades advised Mr. Lansdale's accountant, Mr. Stephen Newman, that Mr. Lansdale's 1981 Form 1040 should reflect the transactions as a contribution to LIV under section 351 of the Internal Revenue Code, and that it was not necessary for Mr. Lansdale to pick up the income as part of the transaction. The Lansdales reported the transactions as advised by Mr. Rhoades. See Rhoades deposition (June 22, 1990) at pages 24-25 and Statement #14 attached to William and Marianthi 1981 Form 1040, U.S. Individual Income Tax Return at Exhibit 50 (Note: "Pacifica Properties" should read "Marina Pacifica").

43. Mr. Rhoades concluded that the "28(a) theory" was sufficiently valid to make it worthwhile pursuing. He was aware of contrary arguments and positions that the government could take with respect to the transactions and told Mr. Lansdale that if challenged, there's always a possibility that he could lose but the risk was worth taking. See Rhoades deposition (June 22, 1990), at pages 20-25.

44. At the LIV Board of Directors' special meeting on June 30, 1981, the treasurer reported that the corporation had received as a contribution to capital, certain property rights known as 1-B consisting of certain distribution rights to a limited partnership in California. The corporation transferred those rights to a limited partnership known as Marina Pacifica [sic Pacifica Properties] in exchange for a 24% limited partnership interest. The treasurer reported that on March 27, 1981, Marina Pacifica [sic Pacifica Properties] had redeemed 95.833% of the corporation's 24% partnership interest

for $3,000,000.00 in cash, $4,000,000.00 in promissory notes and distribution to the corporation of certain oil interests. On March 30, 1981, LIV put the $3,000,000.00 in 90-day 14% certificates of deposit at Bank of America in St. Thomas. See Exhibit 51 at page 2. The interest income from these and subsequent certificates of deposit was reported by LIV on its Form 1120F, Schedule M-1, Line 7, filed with the VIBIR as foreign source income recorded on its books but not included in taxable income and was not reported by the Lansdales on their U.S. Income tax return Form 1040.

45. At the LIV Board of Directors' meeting on September 15, 1981, the fiscal year of the corporation for financial reporting and for the filing of income tax returns was established as February 28th of each year including the first fiscal year. See page 4 of Exhibit 52.

THE REDEMPTION OF LIV'S REMAINING 1% INTEREST IN PACIFICA PROPERTIES

46. At the LIV Board of Directors' meeting on February 16, 1982, the Board authorized the sale of LIV's remaining 1% limited partnership interest in Pacifica Properties. See Exhibit 53.

47. Pursuant to the Purchase of Partnership Interest Agreement, attached as Exhibit 54, paragraph 2 on page 4, provided,

> The partnership will distribute to the Limited [LIV] in full and complete payment for the Redeemed Percentage Six Hundred Sixty Five Thousand Dollars ($665,000) plus Two Hundred Fifty Dollars ($250.00) per day for each day after January 27, 1983 until the Closing as here-after defined ("Redemption Price").

Closing occurred in March, 1983. The total amount received by LIV as the Redemption Price was $684,200.

48. The difference between the original redemption price of a half a million dollars for the remaining 1%

interest and the ultimate amount paid was the result of a formula of that price and an interest rate. In effect, there was a loan to Langslet for a period of time which had nothing to do with the success or failure of Langslet's operation. See Rhoades deposition (June 25, 1990), page 8, Lines 7 through 15.

49. LIV had a basis of $2,083.33 in the 1% limited partnership interest in Pacifica Properties. LIV had a gain of $497,916.67 on the redemption of this interest, plus related interest income of $184,200 which it reported on Schedule M-1, Line 7 of its 1983 Form 1120F U.S. Income Tax Return of a Foreign Corporation.

THE SALE OF THE OIL PROPERTIES BY LIV TO MARINA PACIFICA OIL COMPANY

50. LIV received certain oil and gas properties on March 27, 1981, as previously noted in stipulation No. 33, via the Quitclaim Deed, Bill of Sale and Assignment of Leases attached at Exhibit 44. LIV had a basis in the oil properties of $19,962.28.

51. From March 27, 1981, until the sale in April, 1983, LIV had leased the oil properties to Marina Pacifica Oil Company which operated the properties as provided in the Operating Agreement attached as Exhibit 55.

52. By Notice of Exercise of Option dated 25 February 1983, attached as Exhibit 56, Marina Pacifica Oil Company notified LIV of its exercise of the option to purchase effective April 1, 1983.

53. On April 1, 1983, LIV assigned the oil properties to Marina Pacifica Oil Company pursuant to the assignment of Oil and Gas Leases, attached as Exhibit 57, in exchange for the $6,000,000 Promissory Note from Marina Pacifica Oil Company, attached as Exhibit 58. The Deed of Trust and Assignment of Rents, attached as Exhibit 59, secured the indebtedness of LIV.

54. LIV had a gain of $5,980,037.72 on the sale of the oil properties, which it reported on Schedule M-1, Line 7 of its 1983 Form 1120F U.S. Income Tax Return of a Foreign Corporation.

55. For the relevant periods, payments were made in accordance with the loan amortization schedule attached as Exhibit 60.

SECTION 1277(c)(2)(E) OF THE TAX REFORM ACT OF 1986

56. LIV is the corporation described in Section 1277 (c)(2)(E)(i) of the Tax Reform Act of 1986.

57. The Marina Pacifica/Pacifica Properties transactions are the transactions described in Section 1277(c)(2)(E)(ii) of the Tax Reform Act of 1986.

58. In 1986, William Lansdale contacted California congressman regarding his opposition to the *retroactive* repeal of the "inhabitant rule" pending before Congress. See Exhibit 61.

59. The Honorable Glenn M. Anderson contacted various members of Congress regarding Mr. Lansdale's correspondence concerning the "inhabitant rule." See Exhibit 62.

60. The Honorable Ron de Lugo responded to Congressman Anderson by letter dated July 8, 1986, attached as Exhibit 63.

61. After the Court of Appeals for the Third Circuit decision in *Danbury, Inc. v. Olive* in 1987, representatives of LIV sought, and continue to seek, a "technical clarification" amendment that Section 1277(c)(2)(E) of the Tax Reform Act of 1986 bars the V.I.B.I.R. from assessing deficiencies with respect to the Marina Pacifica/Pacifica Properties transactions.

PENALTIES

62. Stephen L. Newman, C.P.A. is an accountant who has rendered services and advice to Mr. Lansdale at all times relevant in the consolidated cases, up to and including the present date. In 1981 Mr. Newman was familiar with a publication authored by Gustav A. Danielson, Esq., C.P.A., 336-2nd T.M., *Business Operations in the U.S. Virgin Islands*, published by Tax Management, Inc., a subsidiary of The Bureau of National Affairs, Inc. (hereinafter the "Portfolio"), and described to Mr. Lansdale its contents with respect to the so-called "inhabitant rule" and the associated tax analysis set forth therein. See Exhibit 64.

63. Rufus v. Rhoades, Esq. is an attorney who specializes in federal taxation laws, foreign aspects of United States income tax law and related tax planning. Mr. Rhoades was formerly on the faculty at University of Southern California School of Law where he taught corporate and international taxation. He is the co-author of the five volume treatise: "Income Taxation of Foreign Related Transactions" published by Mathew Bender & Co., covering all aspects of United States taxation of foreign matters including taxation of U.S. corporations operating overseas, taxation of U.S. persons operating in U.S. posesssions, taxation of nonresident aliens and foreign corporations by the United States, and foreign tax credit rules. Mr. Rhoades is a frequent lecturer on foreign aspects of U.S. tax law and has lectured on that topic before the Practicing Law Institute, National Tax Advisors Association, International Bankers Association, International Fiscal Association, California State Bar Association, Los Angeles County Bar Association and Beverly Hills Bar Association. He is Past Chairman, Los Angeles County Bar, Section of Taxation. Mr. Rhoades has authored numerous articles on foreign tax matters for various law journals, law reviews and institutes. See Exhibit 65. Respondent reserves the right to object to this Exhibit 65 on the basis of hearsay.

64. Mr. Rhoades stated under oath that Mr. Lansdale called him in early 1981 concerning "a wrinkle in the law that allowed U.S. corporations to get involved in the U.S. Virgin Islands and end up with certain tax advantages that would not be normally available to U.S. corporations". Mr. Rhoades further stated that following that conversation with Mr. Lansdale he spoke with Mr. Newman who referred him to the Portfolio, and that he proceeded to read the Portfolio "from cover to cover". Mr. Rhoades stated that he spoke with Mr. Danielson by telephone, travelled to the U.S. Virgin Islands and conferred there with Mr. Danielson, and as a result became satisfied that the "28(a) Theory" was sufficiently valid to make it worthwhile pursuing. (Rhoades deposition, June 22, 1990, pages 20-22).

65. Mr. Rhoades further stated that after he later discussed Mr. Danielson's analysis with Mr. Lansdale and Mr. Newman "we concluded it was worth pursuing" and Mr. Lansdale retained Mr. Danielson "to implement the whole program". (Rhoades deposition, June 22, 1990, pages 21-22).

66. Mr. Danielson was retained by Mr. Lansdale in the first week of March, 1981 to review his income tax situation with respect to the Marina Pacifica/Pacifica Properties transactions, to perform necessary research, formulate a plan or plans to minimize income taxes, and render a formal written opinion outlining the advantages, problems and risks in the plans proposed. He set forth his advice, previously given orally, in a formal opinion dated September 25, 1981. See Exhibit 66 and Rhoades deposition June 22, 1990, pages 21, 22-23.

67. Mr. Danielson was retained by LIV to render a formal written opinion with respect to (i) LIV's income tax reporting requirements under the Internal Revenue Code in view of certain amendments made to the Code by the Economic Recovery Tax Act of 1981, and (ii) the taxable status of LIV's interest income earned on certificates

of deposit and royalty income earned on U.S. situs oil properties. He rendered his opinion in a letter dated June 15, 1982. See Exhibit 67.

68. Mr. Rhoades stated that Mr. Danieldson "architected . . . the whole transaction of transferring assets to LIV shortly before the closing with Langslet." Mr. Danielson drafted the necessary documents to form LIV and assign to LIV Mr. Lansdale's initial capital contribution. (Rhoades deposition, June 22, 1990, pages 21-22).

69. The decision to form a Delaware corporation to be known as La Isla Virgen, Inc. was based on the legal analysis of the so-called "inhabitant rule" as set forth and discussed in the Danielson Portfolio and as further analyzed by Mr. Rhoades and Mr. Danielson. See Rhoades deposition June 22, 1990, pages 20-21 and Exhibits 66 and 67.

70. On February 12, 1975, Mr. Danielson wrote a letter to Cyril E. King, then Governor of the U.S. Virgin Islands, outlining the mirror theory problems of taxation along with a brief chronological history of attempts to obtain corrective legislation in Washington during the administration of Governor Melvin H. Evans. Two pages of that letter appear as Exhibit 68.

71. At some point in time, Mr. Danielson prepared an analysis entitled "Taxation in the United States Virgin Islands." It is stipulated by the parties that a copy of a portion of that analysis is set as Exhibit 69. The parties are unable to stipulate who made the margin notes, underscoring and similar markings appearing throughout Exhibit 69, and the parties stipulate that no inference is warranted that these markings were made by Mr. Danielson.

Respectfully submitted,

DATED: 10/25, 1990

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DATED: 10/25, 1990

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FACTUAL CHRONOLOGY EXCERPT

The following is a chronology of exents relating to the disposition of Parcel 1-B:

June-December 1980:	Marina Pacifica decides to offer Parcel 1-B for sale; 9 written offers received
October 1980:	Langslet approaches Lansdale and is referred to SCFC; negotiations begin
December 8, 1980:	Lansdale advises SCFC of favorable Langslet proposal forthcoming
December 15/16, 1980:	Lansdale and SCFC meet Langslet and reach agreement on sale of Parcel 1-B; SCFC agrees to suspend all other negotiations; Lansdale letter agreement to Langslet summarizes terms for sale of Lansdales Marina Pacifica limited partnership interest to Langslet; Crocker National Bank issues letter agreeing to finance Langslet acquisition
December 18, 1980:	SCFC notices Langslet that it will sell Marina Pacifica assets in acocrdance with terms reached at 12/16/80 meeting; interest accrual commences on purchase price
December 22, 1980:	Attorneys for Lansdale and SCFC begin to draft partnership withdrawal and distribution agreement
January 15, 1981:	Lansdales execute power of attorney authorizing execution of final agreements implementing 12/16/80 agreement while travelling outside United States
January-February 1981:	Lansdale informed of Virgin Islands "inhabitant rule" tax treatment opportunity
February 24, 1981:	Formal Crocker National Bank commitment letter issued to Langslet
March 6, 1981:	LIV incorporated
March 11, 1981:	Lansdale assigns LIV his Marina Pacifica distribution rights relating to Parcel 1-B

March 12, 1981:	LIV and Langslet form Pacifica Properties; LIV assigns Lansdale's distribution rights as partnership contribution; partnership acquisition agreement obligates partnership to redeem 96% of LIV interest for cash and property consistent with terms of 12/16/80 agreement
March 27, 1981:	Closing date—Marina Pacifica sells Parcel 1-B and the oil properties to Langslet; Langslet contributes Parcel 1-B, the oil properties, and $3,000,000 to Pacifica Properties; Pacifica Properties redeems 96% of LIV partnership interest and agrees to redeem remaining interest for fixed amount plus interest; Lansdale withdraws from Marina Pacifica partnership

STATUTES AND LEGISLATIVE HISTORY

33 V.I.C. § 944. Determinations by district court

Jurisdiction as to increase of deficiency, additional amounts or additions to the tax

(a) The district court shall have judisdiction to redetermine the correct amount of the deficiency even if the amount so redetermined is greater than the amount of the deficiency, notice of which has been mailed to the taxpayer, and to determine whether any additional amount, or addition to the tax should be assessed, if claim therefor is asserted by the Commissioner at or before the hearing or a rehearing.

Jurisdiction over other years

(b) The district court in redetermining a deficiency of income tax for any taxable year shall consider such facts with relation to the taxes for other years as may be necessary correctly to redetermine the amount of such deficiency, but in so doing shall have no jurisdiction to determine whether or not the tax for any other year has been overpaid or underpaid.

Final decisions of district court

(c) For purposes of this chapter and the Virgin Islands income tax law, the date on which a decision of the district court becomes final shall be determined according to the provisions of section 1781 of this title.

33 V.I.C. prec. Ch. 1.

INFORMATION AND RETURNS

PART II. PROCEDURE AND ADMINISTRATION

HISTORY

Revision note. With the exceptions noted in the table below, the provisions of this Part are derived from Subtitle F of the United States Internal Revenue Code of 1954. In most instances the wording of the Internal Revenue Code has been followed exactly, but in a number of sections changes of varying degrees were necessary to conform the section with the legal and administrative structure of the Virgin Islands or with the requirements of the Revised Organic Act of the Virgin Islands. Changes were also made to remove references to provisions of the United States Internal Revenue Code which are not applicable to the Virgin Islands, to convert certain terminology into that used in the Virgin Islands and to integrate the provisions of this Part with those of Part I of this subtitle.

The following table shows the source of the sections appearing in this Part:

DERIVATION TABLE

V.I.C. §	Source
701	6001 IRC
711	6011 IRC
716(a), (b) (1)-(5)	6012 IRC
716(b) (6)	31 U.S.C. 192
717	6013 IRC
718	6014 IRC
721	6020 IRC
722	6021 IRC
723	Act 10/12/56, No. 146, § 5(a)
724	Act 10/12/56, No. 146, § 5(a)
725	Ord. Mun. C. St. C. app. 5/18/38, § 44
731	6031 IRC
732	6032 IRC

V.I.C. §	Source
733	6033 IRC
734	6034 IRC
735	6035 IRC
736	6036 IRC
741	6041 IRC
742	6042 IRC
743	6043 IRC
744	6044 IRC
745	6045 IRC
746	6046 IRC
761	6061 IRC
762	6062 IRC
763	6063 IRC
764	6064 IRC
765	6065 IRC
781	6071(a) IRC
782	6072(a)-(e) IRC
783	Act 10/12/56, No. 146, § 5(a)
784	Act 10/12/56, No. 146, § 5(a)
785	Ord. Mun. C. St. C. app. 5/18/38, § 44
786	6081 IRC
801	6091 IRC
821	6101 IRC
822	6103 IRC
823	6104 IRC
824	6107 IRC
825	6108 IRC
861	6151 IRC
862	6152 IRC
863	6155 IRC
881	6161 IRC
882	6164 IRC
883	6165 IRC
921	6201 IRC
922	6202 IRC
923	6203 IRC
924	6204 IRC
941	6211 IRC
942	6212 IRC

V.I.C. §	Source
943	6213 IRC
944	6214 IRC
945	6215 IRC
991	6301 IRC
992	6302 IRC
993	6303 IRC
1011	6311 IRC
1012	6313 IRC
1013	6314 IRC
1014	6316 IRC
1031	6321 IRC
1032	6322 IRC
1033	6323 IRC
1034	6325 IRC
1051	6331 IRC
1052	6332 IRC
1053	6333 IRC
1054	6334 IRC
1055	6335 IRC
1056	6336 IRC
1057	6337 IRC
1058	6338 IRC
1059	6339 IRC
1060	6340 IRC
1061	6341 IRC
1062	6342 IRC
1063	6343 IRC
1101	6401 IRC
1102	6402 IRC
1103	6403 IRC
1104	6404 IRC
1105	6406 IRC
1106	6407 IRC
1131	6411 IRC
1132	6414 IRC
1161	6501 IRC
1162	6502 IRC
1163	6503 IRC
1181	6511 IRC
1182	6512 IRC

V.I.C. §	Source
1183	6513(a) IRC
1184	6514 IRC
1201	6531 IRC
1202	6532 IRC
1231	6601 IRC
1232	6602 IRC
1251	6611 IRC
1281	6651 IRC
1282	6652 IRC
1283	6653 IRC; Act 10/12/56, No. 146, § 19(a)
1284	6656 IRC
1285	6657 IRC
1286	6658 IRC
1287	6659 IRC
1311	6671 IRC
1312	6672 IRC
1313	6673 IRC
1351	6851 IRC
1361	6861 IRC
1362	6862 IRC
1363	6863 IRC
1381	6871 IRC
1382	6872 IRC
1383	6873 IRC
1421	6901 IRC
1422	6902 IRC
1423	6903 IRC
1461	7101 IRC
1462	7102 IRC
1491	7121 IRC
1492	7122 IRC
1521	7201 IRC
1522	18 U.S.C. 371
1523	7202 IRC
1524	7203 IRC
1525	7206 IRC
1526	7207 IRC
1527	7208 IRC
1528	7209 IRC
1529	7210 IRC

V.I.C. §	Source
1530	7211 IRC
1531	7212 IRC
1532	7213 IRC
1533	7214 IRC
1541	Act 10/12/56, No. 146, § 19(a)
1542	Ord. Mun. C. St. T. & St. J. app. 5/16/38, § 4
1543-1545	Act 10/12/56, No. 146, § 19(b)-(d)
1561	7268 IRC
1581	7301 IRC
1582	7302 IRC
1583	7303 IRC
1591	7321 IRC
1592	7322 IRC
1593	7323 IRC
1594	7324 IRC
1595	7325 IRC
1621	7341 IRC
1622	7342 IRC
1623	7343 IRC
1624	7344 IRC
1661	7401 IRC
1662	7402 IRC
1663	7403 IRC
1664	7405 IRC
1665	7406 IRC
1691	7421 IRC
1692	7422 IRC
1693	7423 IRC
1694	7424 IRC
1731	7451 IRC
1732	7452 IRC
1733	7453 IRC
1734	7454 IRC
1735	7455 IRC
1736	7459 IRC
1737	7461 IRC
1781	7481 IRC
1782	7482 IRC
1783	7484 IRC

V.I.C. §	Source
1784	7485 IRC
1785	7486 IRC
1821	7501 IRC
1822	7502 IRC
1823	7503 IRC
1824	7505 IRC
1825	7506 IRC
1826	7507 IRC
1827	7508 IRC
1861	7601 IRC
1862	7602 IRC
1863	7603 IRC
1864	7604 IRC
1865	7605 IRC
1866	7606 IRC
1891	7622 IRC
1931	7701 IRC
1961	7801 IRC
1962	7803 IRC
1963	7805 IRC
1964	7806 IRC
1965	7851 IRC

A number of provisions enacted by the Legislature and former legislative bodies of the Virgin Islands dealt with the same general matter as provisions of subtitle F of the United States Internal Revenue Code which have been carried into Part II of this subtitle. For this reason those provisions have been omitted from this Code. Among the omitted provisions are the following:

1) Ord. Mun. C. St. T. and St. J. app. May 16, 1938, §§ 4 (part), 6, 7, and 11.

2) Ord. Mun. C. St. C. app. Nov. 24, 1939 (Bill no. 29), § 46.

3) Act Oct. 12, 1956, No. 146, §§ 5(b), 6, 9, 17.

4) Ord. Mun. C. St. T. and St. J. app. Dec. 13, 1951 (Bill no. 102).

5) Ord. Mun. C. St. T. and St. J. app. Sept. 8, 1952 (Bill no. 166).

TITLE 48—TERRITORIES AND INSULAR POSSESSIONS

48 U.S.C. § 1642. Use of certain proceeds for expenditure; income tax obligations of inhabitants

The proceeds of customs duties, the proceeds of the United States income tax, the proceeds of any taxes levied by the Congress on the inhabitants of the Virgin Islands, and the proceeds of all quarantine, passport, immigration, and naturalization fees collected in the Virgin Islands, (less the cost of collecting such duties, taxes and fees as may be directly attributable (as certified by the Comptroller of the Virgin Islands) to the importation of petroleum products until January 1, 1982: *Provided*, That any other retained costs not heretofore remitted pursuant to the Act of August 18, 1978, shall be immediately remitted to the Treasury of the Virgin Islands notwithstanding any other provision of law) shall be covered into the treasury of the Virgin Islands, and shall be available for expenditure as the Legislature of the Virgin Islands may provide: *Provided*, That the term "inhabitants of the Virgin Islands" as used in this section shall include all persons whose permanent residence is in the Virgin Islands, and such persons shall satisfy their income tax obligations under applicable taxing statutes of the United States by paying their tax on income derived from all sources both within and outside the Virgin Islands into the treasury of the Virgin Islands: *Provided further*, That nothing in this chapter shall be construed to apply to any tax specified in section 3811 of the Internal Revenue Code.

(As amended Aug. 18, 1978, Pub. L. 95-348, § 4(c)(3), 92 Stat. 491; Mar. 12, 1980, Pub. L. 96-205, title IV, § 403(a), 94 Stat. 89.)

48 U.S.C. § 1397. Income tax laws of the United States in force; payment of proceeds; levy of surtax on all taxpayers

The income-tax laws in force in the United States of America and those which may hereafter be enacted shall be held to be likewise in force in the Virgin Islands of the United States, except that the proceeds of such taxes shall be paid into the treasuries of said islands: *Provided further*, That, notwithstanding any other provision of law, the Legislature of the Virgin Islands is authorized to levy a surtax on all taxpayers in an amount not to exceed 10 per centum of their annual income tax obligation to the government of the Virgin Islands.

(July 12, 1921, ch. 44, § 1, 42 Stat. 123; Aug. 19, 1976, Pub. L. 94-392, § 5, 90 Stat. 1195.)

TRA 86 Section 1275(b)

For purposes of this title section 28(a) of the Revised Organic Act of the Virgin Islands shall be effective as if such section 28(a) had been enacted before the enactment of this Title and such section shall have no effect on the amount of income tax liability required to be paid by any person to the United States.

TRA 86 Section 1277(c)(2)(A), (B) & (C)

SECTION 1275(b).—

(A) IN GENERAL.—The amendment made by section 1275(b) shall apply with respect to—

(i) any taxable year beginning after December 31, 1986, and

(ii) any pre-1987 open year.

(B) SPECIAL RULES.—In the case of any pre-1987 open year—

(i) the amendment made by section 1275(b) shall not apply to income from sources in the Virgin Islands or income effectively connected with the conduct of a trade or business in the Virgin Islands, and

(ii) the taxpayer shall be allowed credit—

(I) against any additional tax imposed by subtitle A of the Internal Revenue Code of 1954 (by reason of the amendment made by section 1275(b)) on income not described in clause (i) and from sources in the United States,

(II) for any tax paid to the Virgin Islands before the date of the enactment of this Act and attributable to such income.

For purposes of clause (ii)(II), any tax paid before January 1, 1987, pursuant to a process in effect before August 16, 1986, shall be treated as paid before the date of the enactment of this Act.

(C) PRE-1987 OPEN YEAR.—For purposes of this paragraph, the term "pre-1987 open year" means any taxable year beginning before January 1, 1987, if on the date of the enactment of this Act the assessment of a deficiency of income tax for such taxable year is not barred by any law or rule of law.

TRA 86 Section 1277(c)(2)(E)

(E) EXCEPTION FOR CERTAIN TRANSACTIONS.

(i) IN GENERAL. In the case of any pre-1987 open year, the amendment made by section 1275(b) shall not apply to any income derived from transactions described in clause (ii) by 1 or more corporations which were formed in Delaware on or about March 6, 1981, and which have owned 1 or more office buildings in St. Thomas, United States Virgin Islands, for at least 5 years before the date of the enactment of this Act.

(ii) DESCRIPTION OF TRANSACTIONS. The transactions described in this clause are—

(I) the redemptions of limited partnership interests for cash and property described in an agreement (as amended), dated March 12, 1981,

(II) the subsequent disposition of the properties distributed in such redemptions, and

(III) interest earned before January 1, 1987, on bank deposits of proceeds received from such redemptions to the extent such deposits are located in the United States Virgin Islands.

(iii) LIMITATION. The aggregate reduction in tax by reason of this subparagraph shall not exceed $8,312,000. If the taxes which would be payable as the result of the application of the amendment made by section 1275(b) to pre-1987 open years exceeds the limitation of the preceding sentence, such excess shall be treated as attributable to income received in taxable years in reverse chronological order.

ADDITIONS TO TAX FOR NEGLIGENCE AND FRAUD

IRC § 6653(a)

Sec. 6653 [1986 Code]. (a) NEGLIGENCE.—

(1) IN GENERAL.—If any part of any underpayment (as defined in subsection (c)) of tax required to be shown on a return is due to negligence (or disregard of rules or regulations), there shall be added to the tax an amount equal to 5 percent of the underpayment.

(2) UNDERPAYMENT TAKEN INTO ACCOUNT REDUCED BY PORTION ATTRIBUTABLE TO FRAUD.—There shall not be taken into account under this subsection any portion of an underpayment attributable to fraud with respect to which a penalty is imposed under subsection (b).

(3) NEGLIGENCE.—For purposes of this subsection, the term "negligence" includes any failure to make a reasonable attempt to comply with the provisions of this title, and the term "disregard" includes any careless, reckless, or intentional disregard.

Sec. 6653 [pre-1986 Code]

(a) NEGLIGENCE OR INTENTIONAL DISREGARD OF RULES AND REGULATIONS WITH RESPECT TO INCOME, GIFT, OR WINDFALL PROFIT TAXES.—

(1) IN GENERAL.—If any part of any underpayment (as defined in subsection (c)(1)) of any tax imposed by subtitle A, by chapter 12 of subtitle B or by chapter 45 (relating to windfall profit tax) is due to negligence or intentional disregard of rules or regulations (but without intent to defraud), there shall be added to the tax an amount equal to 5 percent of the underpayment.

(2) ADDITIONAL AMOUNT FOR PORTION ATTRIBUTABLE TO NEGLIGENCE, ETC.—There shall be added to the tax (in addition to the amount determined under paragraph (1)) an amount equal to 50 percent of the interest payable under section 6601—

(A) with respect to the portion of the underpayment described in paragraph (1) which is attributable to the negligence or intentional disregard referred to in paragraph (1), and

(B) for the period beginning on the last date prescribed by law for payment of such underpayment (determined without regard to any extension) and ending on the date of the assessment of the tax (or, if earlier, the date of the payment of the tax).

IRC § 6662(c)

Accuracy and Fraud-Related Penalties

(c) NEGLIGENCE.—For purposes of this section, the term "negligence" includes any failure to make a reasonable attempt to comply with the provisions of this title, and the term "disregard" includes any careless, reckless, or intentional disregard.

IRC § 6661 (repealed)

Sec. 6661 [1986 Code]. (a) ADDITION TO TAX.—If there is a substantial understatement of income tax for any taxable year, there shall be added to the tax an amount equal to 25 percent of the amount of any underpayment attributable to such understatement.

(b) DEFINITION AND SPECIAL RULE.—

(1) SUBSTANTIAL UNDERSTATEMENT.—

(A) IN GENERAL.—For purposes of this section, there is a substantial understatement of income tax for any taxable year if the amount of the understatement for the taxable year exceeds the greater of—

(i) 10 percent of the tax required to be shown on the return for the taxable year, or

(ii) $5,000.

(B) SPECIAL RULE FOR CORPORATIONS.—In the case of a corporation other than an S corporation or a personal holding company (as defined in section 542), paragraph (1) shall be applied by substituting "$10,000" for "$5,000".

(2) UNDERSTATEMENT.—

(A) IN GENERAL.—For purposes of paragraph (1), the term "understatement" means the excess of—

(i) the amount of the tax required to be shown on the return for the taxable year, over

(ii) the amount of the tax imposed which is shown on the return, reduced by any rebate (within the meaning of section 6211 (b)(2)).

(B) REDUCTION FOR UNDERSTATEMENT DUE TO POSITION OF TAXPAYER OR DISCLOSED ITEM.—The amount of the understatement under subparagraph (A) shall be reduced by that portion of the understatement which is attributable to—

(i) the tax treatment of any item by the taxpayer if there is or was substantial authority for such treatment, or

(ii) any item with respect to which the relevant facts affecting the item's tax treatment are adequately disclosed in the return or in a statement attached to the return.

(C) SPECIAL RULES IN CASES INVOLVING TAX SHELTERS.—

(i) IN GENERAL.—In the case of any item attributable to a tax shelter—

(I) subparagraph (B)(ii) shall not apply, and

(II) subparagraph (B)(i) shall not apply unless (in addition to meeting the requirements of such subparagraph) the taxpayer reasonably believed that the tax treatment of such item by the taxpayer was more likely than not the proper treatment.

(ii) TAX SHELTER.—For purposes of clause (i) the term "tax shelter" means—

(I) a partnership or other entity,

(II) any investment plan or arrangement, or

(III) any other plan or arrangement,

if the principal purpose of such partnership, entity, plan, or arrangement is the avoidance or evasion of Federal income tax.

(3) COORDINATION WITH PENALTY IMPOSED BY SECTION 6659.—For purposes of determining the amount of the addition to tax assessed under subsection (a), there shall not be taken into account that portion of the substantial understatement on which a penalty is imposed under section 6659 (relating to addition to tax in the case of valuation overstatements).

(c) AUTHORITY TO WAIVE.—The Secretary may waive all or any part of the addition to tax provided by this section on a showing by the taxpayer that there was reasonable cause for the understatement (or part thereof) and that the taxpayer acted in good faith.

H.R. Rep. No. 426, 99th Cong., 1st Sess. 834-835

Reasons for Change

The committee is concerned that the negligence and fraud penalties have not been applied in a large number of cases where their application is fully justified. The committee has consequently modified several aspects of these penalties in order to improve their operation. In addition, however, the committee emphasizes that the IRS and the courts share significant responsibility to ensure that these penalties are fully asserted in appropriate instances.

In particular, the committee believes that the negligence penalty should apply to all taxes under the Code. The committee also believes that while the current special negligence penalty applicable to failure to include as income interest or dividends shown on an information return is appropriate, its scope is too narrow. The committee believes that, if a taxpayer is provided an information return with respect to an item that should appear on the taxpayer's tax return, but the taxpayer neglects to report that item, that taxpayer should be subject to a penalty. Consequently, the committee has expanded the scope of this special negligence penalty so that it applies (absent clear and convincing evidence to the contrary) to any item reported on an information return.

The committee is also concerned that the current applicability of the fraud penalty to the entire underpayment of tax (once the IRS has established fraud with respect to any portion of the underpayment) may decrease the efficacy of this penalty. The committee is concerned that imposing the same penalty on two taxpayers who have identical underpayments, one attributable wholly to fraud and the other attributable only in part to fraud, may be an insufficient deterrent to fraudulent behavior. Consequently, the committee has narrowed the scope of the fraud penalty so that it applies only to the portion

of the underpayment attributable to fraud. The committee has concomitantly increased the level of the penalty. The committee believes that these modifications more appropriately target the fraud penalty to fraudulent behavior.

Explanation of Provision

Negligence

The bill expands the scope of the negligence penalty by making it applicable to all taxes under the Code. The bill also generally redrafts the negligence penalty to make it clearer and more comprehensible. One element of that redrafting involves the provision of a definition of negligence. The bill includes within the scope of the definition of negligence both any failure to make a reasonable attempt to comply with the provisions of the Code as well as any careless, reckless, or intentional disregard of rules or regulations. The bill does not, however, limit the definition of negligence to these items only. Thus, all behavior that is considered negligent under present law will remain within the scope of this negligence penalty. Also, any behavior that is considered negligent by the courts but that is not specifically included within this definition is also subject to this penalty.

The bill also expands the scope of the special negligence penalty that is currently applicable to failures to include in income interest and dividends shown on an information return. The bill expands this provision so that it is applicable to failures to show properly on the taxpayer's tax return any amount that is shown on any information return. This penalty applies to the same information returns that are subject to the penalties for failure to provide information returns, described above (new sec. 6724(d)(1)). Thus, if a taxpayer fails to show properly on the taxpayer's tax return any amount that is shown on an information return, the taxpayer's failure is treated as negligence in the absence of clear and convincing evidence to the contrary. This 5 percent negligence penalty

applies only to the portion of the underpayment attributable to the taxpayer's failure to report.[4]

Fraud

The bill modifies the fraud penalty by increasing the rate of the penalty but at the same time narrowing its scope. First, the bill increases the rate of the basic fraud penalty from 50 to 75 percent. (The time-sensitive component of the fraud penalty is not altered.) Second, the scope of the fraud penalty is reduced so that in effect it applies only to the amount of the underpayment attributable to fraud. The bill does this by providing that, once the IRS has established that any portion of an underpayment is attributable to fraud, the entire underpayment is treated as attributable to fraud, except to the extent that the taxpayer establishes that any portion of the underpayment is not attributable to fraud. This is done so that, once the IRS has initially established that fraud occurred, the burden of proof shifts to the taxpayer to establish the portion of the underpayment that is not attributable to fraud. The committee believes that this rule is appropriate in that these facts are generally within the taxpayer's control. It is nonetheless the intention of the committee that the fraud penalty apply only to the portion of the underpayment attributable to fraud.

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[4] This is determined at the top marginal rate applicable to the taxpayer. Thus, for example, consider a taxpayer who fails properly to report as income $1,000 that was reported on an information return as interest income and who also fails to report an additional $1,500 of income that is not reported on an information return. Assume that the top marginal rate from the income the taxpayer actually reported is 25 percent, but that after $1,500 of additional income, the taxpayer will be in the 35 percent bracket. The $1,000 of income that was reported on the information return is considered to be taxed in the 35 percent bracket. Thus, the penalty is $17.50 ($1,000 x .35 (tax rate) x .05 (penalty rate)).

[Danielson Opinion of 9/25/81]

GUSTAV A. DANIELSON AND COMPANY, P.C.
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September 25, 1981

Mr. William N. Lansdale
Post Office Box 27
Long Beach, California 90740

Dear Mr. Lansdale:

Pursuant to our engagement letter, you have requested that we review your income tax situation with respect to certain transactions, perform whatever research we deem necessary under the circumstances, formulate one or more tax plans designed to minimize income taxes, and issue this opinion letter outlining the advantages, problems and risks inherent in the plans proposed. Our opinion, as set forth below, is based upon the Internal Revenue Code of 1954 as amended, the regulations and rulings thereunder and the controlling court decisions all as they exist at this date and as they apply to income taxation in both the United States and the USVI. Revenue Rulings are merely the legal opinions of government counsel and, in some cases, conflict with our own legal position. In rare instances, we also disagree with Regulations. In all such cases, we have analyzed those Rulings (and Regulations) and expressed the basis for our conclusions. It is, therefore, important that you recognize the Internal Revenue Service has taken a position contrary to our own and announced, formally, the policy which they intend to follow.

THE FACTS

The facts, as we understand, them are as follows. William N. Lansdale and Marianthi Lansdale, husband and wife, were the owners of a limited partnership interest in Marina Pacifica as community property. As a limited partner, Lansdale was entitled to certain distributions relating to a ground lease, oil and gas leases and oil and gas interests with respect to a parcel of real estate located in Long Beach, California, known as Marina Pacifica I-B. Mr. Lansdale has also entered into an agreement with C. Robert Langslet & Son, Inc. to form a limited partnership which was to acquire Pacifica I-B.

La Isla Virgen, Inc. was incorporated on March 6, 1981, under the laws of the State of Delaware. The Certificate of Incorporation includes provisions that the principal office of the corporation shall be located in the USVI, that a majority of the directors must be residents of the USVI and that all directors and shareholder meetings must be held in the USVI. The organizational meeting was held in the USVI on March 11, 1981. Attending were the three directors, Gustav A. Danielson, Rex Danielson and William Lansdale. Also present were stateside counsel, Rufus Rhoades, and Mrs. Lansdale. Mr. and Mr. Lansdale subscribed to, and paid for, 1500 shares of the company for cash in the amount of $1,500, representing the par value of the shares issued. Immediately thereafter, those shareholders offered, and the corporation accepted as paid in capital, the contribution of distribution interests in Marina Pacifica I-B and an interest in an agreement to form a limited Partnership, Pacifica Properties, with C. Robert Langslet & Son, Inc. That contribution was implemented pursuant to Section 351 of the Internal Revenue Code.

The corporation, thereafter, transferred its interests in Marina Pacifica I-B to the newly formed California Limited Partnership, Pacifica Properties, in exchange for a 24 percent interest in that limited partnership in a tax-free transaction pursuant to Section 721 of the Internal

Revenue Code. As a result of those transactions, La Isla Virgen, Inc. is deemed to have held the partnership interest for over 12 months, and its basis in the Pacifica Properties partnership interest is approximately $50,000 to $100,000 being the basis of the I-B property in the hands of the Lansdales prior to their transfer of that property to La Isla Virgen, Inc.

On March 27, 1981, the limited partnership, Pacifica Properties, redeemed 23 percent of the corporation's 24 percent interest in the limited partnership for $3,000,000 cash, 10% notes in the amount of $4,000,000 (payable over 4 years and backed by irrevocable letters of Crocker Bank) and the distribution of certain oil properties located on the I-B tract, resulting in a long term capital gain to the corporation of almost 7 million dollars. The 3 million dollars received in cash from that redemption was invested in Certificate of Deposit at Bank of America's branch in St. Thomas, USVI. That amount was "rolled over" into new CD's as the old ones expired resulting in interest income to the corporation of $107,-333.33.

On April 1, 1981, the corporation leased the oil properties, received in the partnership redemption, on a 10 year lease at the basic rate of $250,000 per year to Marina Pacifica Oil Company (a California corporation), payable quarterly in advance. The lease provides for an annual increase based upon the Consumer Price Index. Thus, through June 30, 1981, the corporation has also earned $62,500 from its oil lease.

Not only do the Certificate of Incorporation and By-laws of La Isla Virgen, Inc. provide for the establishment of USVI residence, but steps have also been taken to center the hub of corporate activity in those islands and to acquire substantial business interests therein. A $50,000 deposit has been placed in escrow as "earnest money" on the purchase of an office building, the total purchase price of which exceeds 1 million dollars. The corporate

bank accounts have been established in the USVI with the USVI corporate officers being signatories thereon. All major corporate actions must be brought before and approved by the Board of Directors in the USVI, the books and records of the corporation are maintained in the USVI, and all corporate reports to the governments and others emanate from the USVI. Soon, the company plans to move its principal offices from its present location to that of the properties purchased and to name its USVI employees, at such location, as the principal officers of the corporation. The principals, Mr. and Mrs. Lansdale, intend to visit the USVI for shareholder and/or directors meetings approximately four times per year to oversee their investments, and it is clear that all corporate decisions will be the result of corporate actions in the USVI. The only decisions of corporate activities not emanating from the USVI, will be those of agents, operating under powers of attorney issued by USVI officers or directors, intended to permit the corporation to conduct its day to day business in overseas branches in a practical manner which is under the full power and authority of the USVI officers and subject to their recall at any time.

OPINION

Subject to the above and to the other caveats herein expressed, it is our opinion that the transfer of distribution rights of a California Limited Partnership to La Isla Virgen, Inc. as a contribution of capital by the sole shareholders is a transaction subject to the nonrecognition of gain provisions of Section 351 of the Internal Revenue Code, and that the transferee corporation takes the property, so transferred, at a tax basis and with a holding period equal to that of the transferor shareholders. Further, the transfer of those rights to a California Limited Partnership by the corporation to a California Limited Partnership in exchange for a 24% Limited Partnership interest therein, does not create a taxable event pursuant to Section 721 of the Internal Revenue

Code, and the corporation takes a substituted basis for its partnership interest and has a holding period therefor which includes the time that the Lansdales and the corporation held the I-B rights. Upon the redemption of 23% of the corporation's 24% Limited Partnership interest, the corporation realized a long term capital gain. It is our opinion that, at the time of the redemption, the corporation was a bona fide inhabitant and permanent resident of the USVI, that it satisfies its U.S. income tax obligations solely by filing its return with and paying its income taxes to the USVI, and that it need not include the gain on the redemption of the 23% Limited Partnership interest on its USVI income tax return.

Since the original drafting of this opinion, sections 897 and 6039C (created by the Foreign Investors In Real Property Tax Act of 1981) have been amended by the Economic Recovery Tax Act of 1981 which amendment purportedly would make the gain on the redemption of the 23% Limited Partnership interest effectively connected with the conduct of a USVI trade or business; taxable, however, by the United States and not by the USVI. It is, nevertheless, our opinion that the latter legislation is defective, that Section 7651 prevents the United States from collecting an income tax on dispositions of U.S. real property interests by corporations resident in the USVI, and that Section 6039C prevents the USVI from collecting income tax on dispositions of U.S. real property interests whether or not effectively connected with the conduct of a USVI trade or business.

THE LAW

Citations, unless otherwise specified, are to the Internal Revenue Code of 1954 as amended, and the regulations and rulings thereunder. As explained below, the USVI uses the United States income tax laws as if separately enacted for the Territory, each jurisdiction applying the Code to the other's citizens and corporations as foreign

persons. Accordingly, references to the laws must be viewed from both U.S. and USVI standpoints. Thus, "USVI" sometimes appears bracketed [USVI] to indicate the "mirroring" of the Code for USVI application. Citations designated "ROA" are to the Revised Organic Act of the Virgin Islands of 1954.

USVI Income Tax Law

The United States Virgin Islands are a United States Possession, purchased from Denmark in 1917, and designated by statute as an Unincorporated Territory [ROA Section 2]. The U.S. income tax laws were first enacted in 1913, four years prior to that acquisition. Unless specifically extended by federal legislation, United States laws (including the Constitution) do not apply to the Possessions and their residents [*Estate of Fairchild v. Com'r.*, 24 T.C. 408(1955)]. Thus, from 1917 until 1921, the income tax statutes of the United States did not apply in the USVI and its residents were free of such levy. In 1921, the Naval Appropriations Act for the Fiscal Year ended June 30, 1922 [48 U.S.C. 1397] ended that status. Section 28(a) of the Revised Organic Act [48 U.S.C. 1642] further changed the complexion of USVI income taxation in 1954 by excusing USVI permanent residents (including U.S. citizens and U.S. domestic corporations) from filing income tax returns with or paying income taxes to the United States. Both the Naval Appropriations Act of 1921 and Section 28(a) of the Revised Organic Act must be understood in their relationship to the Internal Revenue Code to appreciate the unique position of the USVI in tax planning.

The Naval Appropriations Act and the Mirror Theory

Since 1921, the income tax laws in force in the United States of America and those enacted thereafter are likewise in force in the Virgin Islands of the United States, except the proceeds thereof are paid into the Island Treasury [Naval Appropriations Act of 1921, 48 U.S.C.

§ 1397]. The USVI, thus, is a tax jurisdiction separate and distinct from that of the United States, although their respective income tax laws arise from an identical statute applicable to each [*Dudley v. Com'r.*, 258 F.2d 183 (3rd Cir. 1958)]. Those two tax jurisdictions are regarded as foreign, each to the other, and income taxes paid to the USVI qualify for the U.S. foreign tax credit [Section 901 et. seq.].

To convert the United States income tax laws into USVI tax statutes, a word substituion system is used. Whenever the words "United States" appear in the Code, they are to be substituted with the words "Virgin Islands" [Rev. Rul. 73-315, 1973-2 C.B. 225]. In *Vitco v. Govt. of the V.I. and Wheatley*, [560 F.2d 180 (3rd Cir. 1977)] the 3rd Circuit Court of Appeals held that a reverse substitution is also required, i.e., the words "Virgin Islands" are to be substituted with the words "United States." The 3rd Circuit has held that the USVI statutes must reflect a true mirror image of the United States tax system, despite the niceties of language resulting from the mechanical application of word substitution [*Vitco v. Govt. of the V.I., supra*]. That Court has also applied an "equality principle," holding that Congress granted the USVI a tax equivalent to the amount the United States would collect on the same income even if a mechanical application of the law obtains a different result. That principle has been used solely to prevent the USVI from imposing a greater tax than would have been due in the United States, but could be applied to prevent a taxpayer from paying a lesser amount to the USVI.

Accordingly, the United States is a foreign tax jurisdiction vis-a-vis the USVI. All corporations formed under the laws of any jurisdiction other than the USVI (including U.S. domestic corporations) are "foreign" corporations in applying the USVI income tax statutes. Similarly, a USVI corporation is "foreign" in applying the U.S. income tax laws [Rev. Rul. 56-616, 1956-2 C.B.

589]. From the viewpoint of the USVI, citizens of the United States residing in the USVI (unless born or naturalized in the USVI) must be considered as resident aliens, and such U.S. citizens not residing in the USVI must be treated as nonresident aliens [Rev. Rul. 73-315, 1973-2 C.B. 225 withdrawing the obsolescence of I.T. 2946 (XIV-2 C.B. 109)]. On the other hand, a U.S. citizen (unless born or naturalized in the USVI) is not an alien for U.S. tax purposes, no matter where resident.

Section 28(a) ROA, Rev. Rul. 60-291 and § 7651

Section 28(a) of the Revised Organic Act of the Virgin Islands of 1954 [48 U.S.C. § 1642] provides that all persons who are permanent residents (inhabitants) of the USVI shall satisfy their income tax obligations under applicable taxing statutes of the United States by paying their tax on income from all sources into the treasury of the USVI. The term "inhabitants" includes corporations as well as natural persons. [*Vitco Inc. v. the Government of the V.I., supra*, citing *Chicago Bridge & Iron Co. v. Wheatley*, 295 F. Supp. 240 (D.V.I. 1969), 430 F.2d 973 (3rd Cir. 1970), cert. denied, 401 U.S. 910(1971)].

Permanent residence, for individuals, is determined annually on the last day of the taxpayer's taxable year. Although no specific ruling exists with respect to corporations, there is nothing to distinguish it as a "person" and its permanent residence should also be determined on the last day of its taxable year. United States filing obligations are also satisfied by such persons filing solely with the USVI government. [Rev. Rul. 60-291, 1960-2 C.B. 407.]

To prevent subsequent federal income tax legislation from over-riding section 28(a) ROA, § 7651 provides that § 28(a) ROA shall be effective as if such section had been enacted subsequent to the Internal Revenue Code.

USVI Corporate Residence.

A corporation created under the laws of the USVI is always an inhabitant of the USVI even though it does no business and owns no property in the islands. [*Vitco*, supra].

Revenue Ruling 80-40 provides, *inter alia*, that a U.S. domestic corporation can become a "inhabitant" of the USVI within the meaning of § 28(a) ROA, but that § 28 (a) requires such taxpayer to report income derived from all sources both within and outside the Virgin Islands. [See § 882(b) contra.]

There are few guidelines to determine if a corporation has established residence in the USVI because corporate residence is not a concept of the Internal Revenue Code. Revenue Ruling 80-40 sets out a fact situation, in which the corporation is so resident, but fails to establish the specific factors which determine that residency. Probably the actual hub of corporate activity must be in the USVI and possibly it may have to engage in some substantial USVI trade or business. Undoubtedly, it must have some business purpose other than tax avoidance for being so resident.

Taxation of Foreign Persons.

Unlike U.S. [USVI] citizens and domestic corporations, nonresident aliens and foreign corporations are not taxed by the United States [USVI] on their worldwide income. Instead, foreign persons are taxed under two separate regimes only on income from U.S. [USVI] sources or effectively connected with the conduct of a U.S. [USVI] trade or business. Passive income such as dividends, interest, rents and royalties, (generally referred to as "Fixed or Determinable income") is taxed at the rate of 30 percent of gross income without benefit of deductions, although there is an election available to have income from real property treated as if it were effectively connected with the conduct of a U.S. [USVI]

trade or business. Income which is effectively connected with such trade or business is taxed at the usual progressive rates applicable to U.S. [USVI] citizens, residents and corporations. Generally, foreign persons are not subject to tax on U.S. [USVI] source capital gains (long or short term) except those arising from the disposition of U.S. [USVI] real property interests. The following are the principal Internal Revenue Code sections with respect to foreign persons which apply to the problems herein considered.

Section 881 imposes a 30 percent tax on gross amounts derived from sources from within the United States [USVI] which are deemed to be "Fixed or Determinable Annual or Periodical Gains, Profits and Income" received by a foreign corporation or nonresident alien individual, unless such income is effectively connected with the conduct of a trade or business within the United States [USVI]. Such income includes interest, rents, royalties and dividend income as well as other types of passive income.

Section 882 imposes a tax on foreign corporations, at the usual corporate rates provided in §§ 11 and 1201, on taxable income which is effectively connected with the conduct of a trade or business within the United States [USVI], provided the taxpayer is engaged in trade or business within the United States [USVI] during the taxable year.

Section 882(b) provides that in the case of a foreign corporation, gross income includes only income from United States [USVI] sources and income effectively connected with the conduct of a trade or business within the United States [USVI].

Capital gains are not taxable to a foreign corporation unless the gain is effectively connected with the conduct of a trade or business within the United States [USVI] by the taxpayer during the taxable year. Under legislation enacted in December, 1980, foreign taxpayers will

be subject to tax on dispositions of United States [USVI] real property interests for dispositions after June 18, 1980.

The Foreign Investment in Real Property Tax Act of 1980 provides that sales of United States [USVI] Real Property Interests by foreign persons shall be taxed as if effectively connected with the conduct of a U.S. [USVI] trade or business and applies to all dispositions of U.S. [USVI] real property interests after June 18, 1980 [Section 897]. The effect of the Act is to tax foreign corporations and nonresident aliens on the disposition of U.S. [USVI] real estate, usually at capital gains rates. The Economic Recovery Tax Act of 1981 amended § 897 (c) to define U.S. real property interests to include real property interests situated in the USVI. The effect of the amendment is to make gains from the disposition of a U.S. real property interests "effectively connected" with the conduct of a USVI trade or business and to make gains from the disposition of USVI real property interests effectively connected with a U.S. trade or business. Section 6039C was also amended to provide that the tax is payable to the United States if the real property interest is located in the United States and payable to the USVI if the real property interest is located in the USVI.

Sections 861-863 of the Internal Revenue Code provide "source" rules which are highly artificial, but designed to give some aura of certainty to the sources of various characterizations of income. Income from the rental or sale of real property has its source where the real property is located.

Generally, only United States [USVI] source income is considered to be effectively connected with the conduct of a trade or business within the United States [USVI] [§§ 872(a); 882(b)]. Effectively connected income (unlike fixed, determinable income), however, can include certain non-United States [non-USVI] source income if

a United States [USVI] fixed place of business is a material factor in the realization of such income. Rents or royalties for the use of intangible property, dividends, interest, gains from sales of securities, and sales of goods or merchandise are within this latter category. [§ 864 (c) (4)]. Even without a fixed place of business, gains from dispositions of U.S. real property interests are effectively connected with the conduct of a USVI trade or business and gains from dispositions of USVI real property interests are effectively connected with the conduct of a U.S. trade or business.

The "anti-avoidance" provisions of the Code, (CFC, PHC, FPHC and Accumulated Earnings rules), naturally, also apply on a mirrored basis. In their application, however, U.S. citizens resident in the U.S., are nonresident aliens and U.S. domestic corporations are foreign to the USVI. Thus, a USVI corporation cannot be a FPHC to the USVI although it could be so in the United States. Similarly, the USVI can characterize a Delaware corporation as a Foreign Personal Holding Company or as a Controlled Foreign Corporation if such corporation has the requisite percentage holdings by USVI persons. It is the interplay of the U.S. application of the Code and the USVI mirrored image of the statute which permits tax opportunities and unseen pitfalls.

Personal Holding Companies.

A 70 percent surtax is imposed upon the undistributed personal holding company income (as defined in § 545) of any corporation (foreign or domestic) which

> (1) derives 60 percent or more of its "adjusted ordinary gross income" during the taxable year from personal holding company income; and
>
> (2) is more than 50 percent owned, directly or indirectly, by or for not more than five individuals at any time during the last half of the taxable year [§ 542(a)].

A foreign corporation which is classified as a PHC is subject to the surtax with respect to its U.S. [USVI] source income [Regs. § 1-541-1 (b)]. A foreign corporation is not classified as a PHC if:

(1) it is a Foreign Personal Holding Company as defined in § 552 [§ 542(c)(5)], or

(2) all of its stock is owned by nonresident aliens (directly or indirectly) through foreign estates, foreign trusts, foreign partnerships, or other foreign corporations [§ 542(c)(7)]. The stock ownership exception does not apply if the corporation has income from certain personal service contracts [§§ 542 (c)(7); 543(a)(7)].

Personal holding income is that derived from dividends; rents (unless rents constitute 50 percent or more of the corporation's income); mineral, oil and gas royalties subject to limitations; copyright royalties; produced film rents; use of property by a shareholder; certain personal service contracts; and income from estates and trusts.

Generally, "mineral, oil and gas royalties" may be determined by reference to Subchapter I of the Code. [See Regs. § 1.543-1(b)(11)(ii)]. Income from working interest are not "royalties," thus not PHC income.

Accumulated Earnings Tax.

Sections 531 et. seq. provide for a penalty tax of 27½ percent on the first $100,000 and 38½ percent on amounts over $100,000 of taxable income unreasonably accumulated by a foreign or domestic corporation with the purpose of avoiding the income tax to its shareholders by permitting earnings and profits to accumulate instead of being distributed. The penalty tax is applicable to foreign corporations only to the extent the accumulation arises from earnings derived from U.S. [USVI] sources, and only if any of its shareholders are subject to U.S. [USVI] tax by reason of being

(1) citizens or residents of the U.S. [USVI]

(2) nonresident alien individuals subject to U.S. [USVI] income tax; or

(3) foreign corporations in which a beneficial interest is owned directly or indirectly by any shareholder described in (1) or (2).

Under present regulations, the penalty tax applies only on accumulations which avoid the imposition of tax on individual shareholders. If the accumulation is designed to avoid the 30 percent (or lower treaty rate) withholding tax on distributions to foreign corporations, the penalty tax cannot be imposed. On December 19, 1980, Treasury announced notice of proposed rules which would change that result. If implemented, those rules will imposed the penalty tax on a corporation availed of, to avoid the withholding tax by accumulating earnings. In determining whether the purpose to avoid tax with respect to foreign corporate shareholders exists, consideration will be given to the extent to which dividends will be exempt from or subject to a reduced rate of tax by virtue of an income tax treaty. Note that no income tax treaties are in effect in the USVI.

Transfers To Controlled Corporations.

Section 351 provides in part, that no gain or loss be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock or securities in such corporations and immediately after the exchange such person or persons own stock of the corporation possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of the corporation.

Transfers To Partnerships.

Section 721 provides that no gain or loss shall be recognized to a partnership or to any of its partners in the case

of a contribution of property to the partnership in exchange for an interest in the partnership.

DISCUSSION OF THE ISSUES

The facts of your particular situation and the applicable law are discussed above. Here, we consider the issues so presented, the attendant risks, and the problems involved in the practical implementation of the plan.

U.S. Domestic Corporations Resident In The USVI.

Under § 351, appreciated property may be transferred to a U.S. domestic "controlled" corporation by a U.S. taxpayer without incidence of income taxation on such disposition of the property, if the taxpayer makes such transfer solely in exchange for stock or securities of the corporation. Accordingly, the taxpayer takes a "substituted" basis for the shares he receives (the basis of such shares in his hands is the same as his basis in the transferred property immediately prior to the transfer) and the corporation takes a "carry-over" basis in the property received (the basis of the property to the corporation is the same as it was in the hands of the transferor). Thus, a subsequent disposition of that property by the corporation will result in gain or loss being realized.

If the transferee corporation is, or becomes, a USVI permanent resident, it no longer files income tax returns with the U.S., satisfying that obligation, instead, by filing solely with the USVI. Since such corporation is a "foreign" corporation vis-a-vis the USVI, it reports only its income which is from USVI sources or which is effectively connected with the conduct of a USVI trade or business. Thus, should it dispose of property received in a taxfree § 351 transfer and, if the income from the disposition is neither from USVI sources or effectively connected with the conduct of a USVI trade or business, it will not be required to report gain on the sale or disposition.

This device, nevertheless, can be regarded only as a tax deferral unless later coupled with an installment sale of the corporate shares (or § 337 liquidation) with the taxpayer moving his residence to the USVI in some taxable year following the year of sale or liquidation. A payment of dividends by the corporation will be fully taxable in the hands of the U.S. resident shareholder and a liquidation of the corporation will be taxed as a capital gain in the United States.

The plan first contemplates the transfer of appreciated interests in the I-B property to Isla Virgen, Inc., U.S. domestic corporation. In order to avoid tax on the transfer of appreciated assets, the provisions of Section 351 must be met. Thus, the property must be transferred solely for securities issued by the transferee corporation and the transferor must control 80 percent of the respective transferee's shares immediately after the transfer. Here, both the 80 percent test and "solely for securities" tests are satisfied. Similarly, Isla Virgen's transfer of the I-B interests in exchange for the limited partnership interest satisfies the nontaxable exchange requirements of Section 721. Thus, prior to the redemption of the 23% partnership interest, Isla Virgen holds the 24% partnership interest at a tax basis of approximately $50,000 to $100,000.

The basic features of the plan are founded in the facts that the United States and the USVI are separate and distinct tax jurisdictions, each considered foreign to the other and that under Section 28(a) of the Revised Organic Act, a permanent resident of the USVI satisfies its U.S. income tax obligations solely by filing its returns with and paying its income taxes to the USVI. La Isla Virgen, Inc. is a foreign corporation with respect to the USVI. Income from United States sources is considered to be from foreign sources in applying the Internal Revenue Code as the taxing statutes of the USVI. Under this interpretation, La Isla Virgen, Inc. avoids all taxation

on income derived from or effectively connected with the United States or other foreign jurisdictions. This is possible because, as a USVI permanent resident, it is not subject to U.S. tax and, under the mirror system of applying the Code in the USVI, it is liable to USVI tax only on income derived from or effectively connected with the USVI.

Section 897 provides that gain or loss of a nonresident alien individual or foreign corporation from the disposition of a USVI Real Property Interest shall be deemed to be effectively connected with the conduct of a USVI trade or business as if the foreign taxpayer was engaged in such trade or business during the taxable year. The effect, of course, is to tax foreign taxpayers on the disposition of USVI real property interests. Until recently, a USVI real property interest was defined to be an interest in real property located in the USVI. The Economic Recovery Tax Act of 1981 amended § 897(c) to provide that a USVI real property interest also shall include real property interests located in the United States. Thus, gains on the disposition of United States real estate by corporations foreign to the USVI (including U.S. corporations) are now deemed to be effectively connected with the conduct of a USVI trade or business whether or not the corporation is resident in the USVI and without regard to its having any nexus whatsoever with the USVI. If, however, the real property interest is situated in the United States, § 6039C provides a special rule that the foreign taxpayer shall file any return and pay any tax thereon to the United States. That forecloses the USVI from claiming tax on dispositions of United States real property interests, whether or not the taxpayer is an inhabitant and permanent resident of the USVI. The partnership interest, because of the underlying assets (the I-B interests) is a real property interest situated in the United States.

Because § 28(a) provides that USVI inhabitants satisfy U.S. income tax obligations by filing returns with and paying tax to the USVI, § 6039C is obviously in conflict by requiring such person to file returns with and pay taxes to the United States. Section 7651 provides that for purposes of the Internal Revenue Code, § 28(a) shall be effective as if enacted subsequent to the Internal Revenue Code. Thus, it is our opinion that § 28(a) takes precedence over any conflict with § 6039C and that La Isla Virgen, Inc., as a resident of the USVI, need not report gains from dispositions of United States real property interests to the United States.

It is, nevertheless, our opinion that the effect of § 897 is to dictate that gains from dispositions of U.S. real property interests, after June 18, 1980, are effectively connected with the conduct of a USVI trade or business. As such, a U.S. domestic corporation (or for that matter any foreign corporation or nonresident alien individual including U.S. residents), having made such disposition would, without more, be required to file a return with the USVI and pay tax thereon. The law does not distinguish between resident and nonresident foreign corporations and residence is not a factor except with respect to § 28(a). Section 6039C was designed to take care of that result by providing that nonresident alien individual or foreign corporation subject to tax under § 897 shall pay any tax and file any return with the United States with respect to U.S. situs real property interests and with the USVI with respect to USVI real property interests. It appears, therefore, that a foreign corporation or U.S. domestic corporation need not report gains from dispositions of U.S. situs real property interests on a USVI return. That is especially true of a U.S. domestic corporation, even if resident in the USVI. Even though it satisfies its U.S. income tax obligations by filing with the USVI, Isla Virgen, Inc., a U.S. domestic corporation, has no U.S. income tax obligations pursuant to § 897.

Thus, it is our opinion that La Isla Virgen, Inc. need not file a return or pay taxes to the USVI with respect to dispositions of U.S. situs real property interests by virtue of the dictates of § 6039C.

A corporation resident in the USVI, if domestic to the U.S., may be formed, liquidated, or merged without running afoul of Section 367 under either USVI or U.S. tax jurisdictions. If all shareholders are U.S. persons, neither jurisdiction may impose taxes under Section 1491. The corporation will not be a Controlled Foreign Corporation in either jurisdiction (unless combined total voting power is more than 50 percent owned by V.I. persons) and will be free to act as a base company for foreign sales with impunity. The corporation should escape Personal Holding Company status by the V.I. tax authorities if no shareholders are V.I. persons, and if it does not engage in personal service contracts. It should also escape U.S. PHC taxation since the U.S. has no tax jurisdiction over a V.I. inhabitant. Since the corporation is domestic to the U.S., the U.S. cannot deem it a Foreign Personal Holding Company. FPHC status is avoided in the V.I. if none of the stockholders are USVI citizens or residents.

The problems which can frustrate this idyllic tax result are fourfold, to wit: (1) Lack of precedent and the "equality principle," (2) The Service's position in Revenue Ruling 80-40, (3) Problems inherent in the establishment of corporate residence in the USVI, and (4) doctrinaire law.

The issues of corporate residence and USVI taxation of U.S. domestic income of such corporate inhabitants has never been litigated. In some cases, (*Chicago Bridge and Iron, Vitco*, supra) the 3rd Circuit Court of Appeals has imposed an "equality" principle which ignores the mechanics of the Internal Revenue Code if the USVI would, as a result, collect greater taxes than the United States would have collected on the same income. The Court has stated:

> "(T)he scheme of the statute is to impose a tax obligation to the Virgin Islands equivalent to what the United States would collect on the same income but for the mirror system." . . . "More basically Congress has aided the Virgin Islands by giving them the same tax, not more, than the United States would otherwise collect on the same income."

While the equality principle has been applied to prevent the USVI from collecting greater taxes than would have obtained in the United States, the principle can be used as a sword as well as a shield. The Court could easily hold that since the scheme of the statute is to impose a USVI tax obligation equivalent to that which the United States would collect on the same income, that Congress aided the USVI by giving the same tax, not less than the United States would otherwise collect. Despite the fact that the 3rd Circuit holding is converse to that of the 9th Circuit sitting en banc [*Sayre v. Riddell*, 395 F.2d 407 (9th Cir. 1968)], we believe the "equality" principle to be the most dangerous obstacle to the successful implementation of this plan.

Neither the Internal Revenue Service nor the USVI tax authorities have favored or argued the equality principle, and have argued strenuously against it in briefs filed in application for certiorari to the United States Supreme Court in *Chicago Bridge & Iron* and *Vitco* (both denied). They have traditionally preferred to take a more technical approach and not disregard the Code as mirrored. In Revenue Ruling 80-40, discussed below, the Service states that based upon the language of Section 28(a) of the Revised Organic Act, a U.S. domestic corporation which is an inhabitant of the USVI is taxed as if it were a USVI domestic corporation, i.e., on its worldwide income. The language of Section 28(a) to which the Service refers, states that:

> "such persons shall satisfy their income tax obligations under the applicable taxing statutes of the

> United States by paying their tax on income derived from all sources both within and outside the Virgin Islands into the treasury of the Virgin Islands."

At first glance, the Service's position would seem reasonable. We do not, however, believe that to be the law and believe that the Service has used that statement only for its in terrorem effect. First, it must be noted that 28(a) applies to individuals as well as corporations. Thus, some taxpayers (individuals resident in the USVI) *are* taxed on their worldwide income and the language of the statute is used to emphasize the fact that such individuals are not liable to the U.S. for income taxes on non-USVI source income. Next, receipts are not subject to income tax unless they constitute "income" in the first instance. Section 882(b) provides, in part, that in the case of a foreign corporation, gross income includes only income derived from sources within the USVI and income effectively connected with the conduct of a USVI trade or business. Thus, unless the receipt or accrual falls within the definition of "gross income" in the first instance, it is not "income" for the purposes of Section 28(a) from whatever source derived. The language of Section 882(b) or similar language such as "gross income shall not include . . ." is used to exempt other types of income such as interest on tax exempt bonds and insurance proceeds. If the Service's position were upheld, it would necessarily follow that the USVI is to tax those exempt items of income. Further, the Service's position would have the strange effect of taxing European source income of, say, a Netherlands or UK company were the company to become resident in the USVI. The author of Revenue Ruling 80-40 has privately agreed with me that the latter result clearly is not the law.

The legislative history of Section 28(a) does not reflect any intention of Congress to tamper with the application of the mirror system of applying the Code in the USVI. That system was first pronounced by I.T. 2946 in 1935.

The mirror system was again proclaimed in 1973 [Rev. Rul. 73-315], 19 years after the enactment of 28(a). The purpose of 28(a) was, instead, to leave the Code intact but to permit the USVI to collect taxes on taxable income from its inhabitants without those taxes being diminished by tax credits by reason of income tax obligations to the United States. Finally, the Senate Committee Report with respect to the addition of Section 934 to the Code [S. Rep. 1767, 86th Cong., 2d Sess. 1960] in referring to Section 28(a) states that:

> "The effect of this change was to require inhabitants of the Virgin Islands, namely permanent residents of those islands, to pay their entire income taxes to the Virgin Islands even though part of their income was derived from sources within the United States."

The report continues (with respect to Section 934):

> "The first exception relates to United States . . . corporations and, in general, that subsidies can be paid . . . under much the same conditions as those . . . in the case of U.S. corporations carrying on a trade or business in most other U.S. possessions (Sec. 931 of the Code)."

That statement is significant because a Section 931 corporation, at that time, could derive up to 20 percent of its income from non-possession sources without being subject to tax thereon. The same provision (for a USVI exempt company to earn up to 20 percent of its gross income from non-USVI sources) was made a part of Section 934. It is clear that Congress intended similar treatment in the USVI and believed that a U.S. domestic corporation resident in the USVI (much less a foreign company so resident) was not subject to USVI tax on income derived from outside the USVI and that Section 28(a) had in no way altered that result.

Thus, it is our legal opinion that the position taken by Rev. Rul. 80-40 is not the law and that La Isla Virgen,

Inc., a U.S. corporation foreign to the USVI and resident in the USVI, is taxable only on its USVI source income and income effectively connected with the conduct of a USVI trade or business. The Ruling, nevertheless, expresses the Service's position and its determination to attack those avoiding tax on U.S. source income through the device here described.

The next problem concerns the establishment of the U.S. domestic corporation as a Permanent Resident of the USVI. While rules and regulations provide some guidelines for the establishment of individual residence (Rev. Rul. 60-291, supra and regulations under Sections 911 and 871) there are few, if any companion provisions for corporations. Corporate residence is not generally a concept of U.S. taxation. Until the issuance of Revenue Ruling 80-40 in February 1980, it was not known whether the Service would recognize such corporate residence or whether they would take the position that a corporation cannot migrate. In that ruling, the Service agreed that a U.S. domestic corporation can be a permanent resident of the USVI. The ruling states:

> "In the present situation, all of the officers and some directors of S are Virgin Islands residents. All significant business operations, shareholder meetings and Board of Directors meetings are conducted in the Virgin Islands, and S meets the percentage tests of section 934(b) of the Code. In addition S is carrying on a trade or business within the meaning of section 864(a). *This is sufficient* to constitute S a permanent resident, and therefore an inhabitant, of the Virgin Islands for purposes of section 28(a) of the R.O.A."

The problem is that the Service fails to state which factors are necessary to such residence and that which would be insufficient. Section 934(b) of the Code referred to in the ruling provides that 80 percent of the gross income of the corporation must be derived from

USVI sources and that 50 percent of gross income must be from the active conduct of a USVI trade or business. That section, however, is solely for the purpose of determining whether the corporation can qualify for USVI industrial incentive benefits and is in no way interrelated to 28(a) provisions of permanent residence. Section 864 (a) merely defines the term "produced."

Probably, a Court would use an "all the facts and circumstances" test to determine whether La Isla Virgen, Inc. is resident and demand that the hub of corporate activity actually be in the USVI. It is certainly desirable that the company be engaged in a USVI trade or business and that decisions made with respect to non-USVI operations be made, or at least approved, by the officers and directors in the USVI. It should be a USVI active business, i.e., not a relatively passive one which merely constitutes a trade or business for purposes of taxation. If possible, all officers should be bona-fide residents of the USVI and a majority of the directors should be so resident. A Principal, however, should be one of the directors and should travel to the USVI as regularly as possible to attend meetings (all of which should be held in the USVI). If possible, the shareholders should also travel to the USVI for shareholder meetings rather than appear by proxy. Executives who are USVI residents should have both the ability and the authority to exercise complete management and control. If a service company employee, attorney, accountant, etc. is on the board, he should be active in the affairs of the company and not be a mere dummy or person of convenience. It is emphasized that "letter box" and "wall plaque" companies such as are often maintained in tax havens are doomed to failure if attacked and that the USVI operations must be of substance not form. Additionally, the corporate financial books and records should be maintained in the USVI and if there are U.S. foreign branch operations, they should report to the USVI principal office on a regular basis and forward all financial data

for recording in the USVI journals and ledgers. The corporate books should be audited in the USVI, even if U.S. auditors travel there for purposes of the audit. Receipts and disbursements should, to the greatest degree possible, be made to and by USVI resident employees and officers using USVI bank accounts. Decisions to acquire or dispose of interests should be made in the USVI and communications between the USVI and other branches should not indicate that instructions or orders emanate from outside the USVI or that USVI officers and directors are to sign documents without the related transaction having been discussed and decided upon in a meeting held in the USVI. All corporate documentation (including articles, bylaws, minutes of meetings, correspondence and billings) should be indicative of USVI residency.

If La Isla Virgen, Inc. should fail to meet Court approval as a resident of the USVI, its tax returns would have been filed with the wrong jurisdiction and the statute of limitations may never have commenced to run. In some case, the corporation may have unreasonably accumulated earnings and profits and thereby become liable for penalty taxes. It may also be characterized as a Personal Holding Company subject to 70 percent penalty taxes. The corporation may, therefore, pay taxes greater than those incurred had the plan not been attempted. While the corporation may run the risk of violating the equality principle or finding that a court agrees with Revenue Ruling 80-40 (that it should be taxed as if it were a USVI domestic corporation), such holdings will probably impose the tax which would have applied had the plan not been undertaken in the first place, although interest may also be due and penalties may apply for failure to file proper estimated tax returns. The one thing La Isla Virgen, Inc. cannot do, however, is fail the residency test by operating in a slovenly manner and not having the actual and substantive hub of its operations in the USVI.

The recognition of the attacks which this tax plan may face in no way is indicative of fraud in conceiving and implementing such plan. It is our legal opinion that a court would more likely than not find our position and interpretation of the statutes to be valid and uphold the taxpayer in his contentions that La Isla Virgen, Inc. should file solely with the USVI and that taxes are due to the USVI only on USVI source income and income effectively connected with the conduct of a USVI trade or business.

There is, nevertheless, concern with those who fail to take adequate steps to establish and maintain USVI residency of the corporations. If the hub of corporate activity is not in the USVI and if management and control decisions are not actually made by the directors in meetings in the USVI, the corporation probably is not resident there. Anyone signing a tax return, filing a return with the USVI without believing La Isla Virgen, Inc. to be resident therein, or failing to file a U.S. return when there is inadequate reason to believe La Isla Virgen, Inc. to be a USVI resident, has fraudulently attempted to evade or defeat tax [Section 7201], willfully failed to file returns [Section 7203] and filed fraudulent and false statements [7206] as well as run afoul of other possible criminal sanctions. It is, therefore, absolutely necessary that the USVI residence of La Isla Virgen, Inc. be real and substantial and not merely "make believe."

The doctrinaire law of the courts presents the final threat to the success of the plan and is closely related to the residence issue. The doctrines of substances over form, sham transactions, step transactions and business purpose are closely related and, while distinguishable, the doctrines overlap one another to a great degree. Substance over form merely states the position of the courts that the casting of a given transaction in a given form will be ignored if that form does not accurately reflect the substance of the transaction itself. In the present

case, if the form of the transaction is the establishment of the corporation as a USVI resident, but the substance is otherwise, the substance will prevail.

Step transactions are a series of supposedly independent transactions which comply mechanically with Code provisions, leading to a lower tax being imposed than if the end result had been accomplished by a single transaction. Thus, a series of transfers, each with its own independent result, will be "collapsed" by the court and treated as mere steps in a single transaction. In planning the transfer of property, care must be taken that subsequent transactions are not of such nature that the court will view the original transfer as part of the subsequent transactions.

Sham transactions are those with a false and illusory aura of actuality and are similar to form not accurately reflecting substance. If the transaction, or its setting, are mere pretenses which attempt to obtain a different tax result by sleight of hand execerises, the court will take cognizance of the "Houdini" effect and ignore it as a pretense and sham. Again, the importance of actually placing the corporate being in the USVI cannot be underestimated if the plan is to survive scrutiny.

The business purpose doctrine permits the court to examine a given situation to determine whether a transaction has a true business purpose other than the avoidance of income taxes. The courts have been generous in recognizing that business purposes may co-exist with tax avoidance, and not piercing the corporate veil merely because the taxpayer enjoys tax advantages from the particular structure of the entities employed. If, however, a blatant attempt is made to obtain tax advantages and there is no discernible business purpose attached thereto, the "business purpose" doctrine will be imposed and the corporate entity disregarded or treated as a mere agent for the beneficial owner. Closely related to the doctrine is the matter in which the principal treats the corporation.

If treated as if it were just another pocket in his trousers rather than an independent entity governed by corporate law, the courts will ignore the entity as being merely the alter-ego of the beneficial owner. If, on the other hand, the corporation has been well reared and cared for, it will be deemed to have an independent existence with a business purpose separate from the tax avoidance motives of its owner, and will be recognized as being its own man with its own tax obligations.

We believe if the company actually establishes its principal office in the USVI, establishes a substantial USVI business, and takes care to actually manage and control all company transactions, that there is little to fear from doctrinaire law.

Applying those principles here, we believe that La Isla Virgen, Inc. has been established as a bona fide resident of the USVI, that all principle transactions of the corporation have been those of the Board of Directors meeting in the USVI or those of agents appointed by such Board, that steps have been taken to establish a substantial and real USVI business and investment policy, and that the hub of its business activity is actually in the USVI. So long as those actions and policies are maintained, it is our opinion that La Isla Virgen, Inc. is an inhabitant of the USVI within the meaning of Section 28(a) of the Revised Organic Act.

We shall be pleased to meet with you to discuss the matter at your convenience, and shall be happy to aid in the implementation of the tax planning at your request.

Sincerely,

/s/ Gustav A. Danielson
GUSTAV A. DANIELSON

[Danielson Opinion of 6/15/82]

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June 15, 1982

La Isla Virgen, Inc.
P.O. Box 6714
St. Thomas, U.S. Virgin Islands 00801

PRIVATE AND CONFIDENTIAL
Attention: Board of Directors and Legal Counsel

Gentlemen:

You have requested our written legal opinion with respect to the corporation's income tax reporting requirements in view of the amendments made to §§ 897 and 6039C of the Internal Revenue Code by the Economic Recovery Tax Act of 1981. You have also requested that we opine on the taxable status of the corporation's income earned from interest on certificates of deposit and from royalties earned on U.S. situs oil properties.

Our opinion, as set forth below, is based upon the Internal Revenue Code of 1954 as amended, the regulations and rulings thereunder and the controlling court decisions all as they exist at this date and as they apply to income taxation in both the United States and the USVI. Citations, unless otherwise indicated, are to that Code, regulations and rulings. Citations to "§ 28(a)" refer to § 28(a) of the Revised Organic Act of 1954 as amended [48 U.S.C. § 1642]. Where conflicts in law exist, we have formulated our opinion on that which we believe to be the view which would prevail in a court of competent jurisdiction.

It is our opinion that:

1. La Isla Virgen, Inc., a Delaware corporation, is a bona fide and permanent resident of the U.S. Virgin Islands within the meaning of § 28(a) of the Revised Organic Act of 1954 [48 U.S.C. § 1642].

2. La Isla Virgen, is *required* to satisfy its income tax obligations under the applicable taxing statutes of the United States by paying its tax on income to and filing its income tax returns solely with the Government of the U.S. Virgin Islands.

3. Anything in I.R.C. § 6039C(f) to the contrary notwithstanding, La Isla Virgen, Inc. is not required to file any income tax return with the Internal Revenue Service of the United States and should not file such return for any past taxable year or for any future year that the corporation is a permanent resident of the U.S. Virgin Islands.

4. The corporation is required to report only its income from USVI sources and that which is effectively connected with its USVI trade or business. Even though the corporation's gains on dispositions of real property interests situated in the United States are deemed to be effectively connected with USVI trade or business, the corporation need not report such gains on its USVI income tax returns. Interest earned by the corporation on certificates of deposit and other deposits with banks located in the USVI is neither from USVI sources nor effectively connected with a USVI trade or business and need not be reported on its USVI income tax returns. Royalties earned from oil properties located in the United States is not subject to income tax in the USVI and need not be reported.

THE FACTS

The facts upon which we base our opinion are set forth in our opinion letter addressed to Mr. William N. Lans-

dale, dated September 25, 1981, amended and updated as follows:

1. The April 1, 1981 lease on certain oil properties located in the United States has been replaced with a new operating agreement under which the corporation receives royalties.

2. The purchase of the office building located in the USVI has been closed and the corporation is operating that property as a substantial USVI trade or business through its officers and agents. The operation of that rental property is the major corporate activity.

3. The undersigned has resigned as officer and director and has been replaced by Mr. John Foster who is also the operating agent of the corporation's business.

4. Several additional directors meeting have been held in the USVI and all corporate transactions have come before that board and/or been approved and executed by the USVI officers and directors.

THE LAW

The Naval Appropriations Act and the Mirror Theory

Since 1921, the income tax laws in force in the United States of America and those enacted thereafter are likewise in force in the Virgin Islands of the United States, except the proceeds thereof are paid into the Island Treasury [Naval Appropriations Act of 1921, 48 U.S.C. § 1397]. The USVI, thus, is a tax jurisdiction separate and distinct from that of the United States, although their respective income tax laws arise from an identical statute applicable to each [*Dudley v. Com'r.*, 258 F.2d 183 (3rd Cir. 1958)]. Those two tax jurisdictions are regarded as foreign, each to the other.

To convert the United States income tax laws into USVI tax statutes, a word substitution system is used. Wherever the words "United States" appear in the Code, they are to be substituted with the words "Virgin Islands" [Rev. Rul. 73-315, 1973-2 C.B. 225]. In *Vitco v. Govt.*

of the V.I. and Wheatley, [560 F.2d 180 (3rd Cir. 1977)] the 3rd Circuit Court of Appeals held that a reverse substitution is also required, i.e., the words "Virgin Islands" are to be substituted with the words "United States." The 3rd Circuit has also held that the USVI statutes must reflect a true mirror image of the United States tax system, despite the niceties of language resulting from the mechanical application of word substitution [*Vitco v. Govt. of the V.I., supra*].

Accordingly, the United States is a foreign tax jurisdiction vis-a-vis the USVI. All corporations formed under the laws of any jurisdiction other than the USVI (including U.S. domestic corporations) are "foreign" corporations in applying the USVI income tax statutes [Rev. Rul. 56-616, 1956-2 C.B. 589].

A foreign corporation includes in gross income (for USVI reporting) only income from USVI sources and income effectively connected with the conduct of a USVI trade or business [§ 882(b)]. Interest on deposits with persons carrying on the banking business (unless effectively connected with the conduct of a USVI trade or business) is not from USVI sources [§ 861(a)(1)(A)]. Royalties from properties located without the USVI is gross income from sources without the USVI [§ 862(a)(4)].

Section 28(a) ROA, Rev. Rul. 60-291 and § 7651

Section 28(a) of the Revised Organic Act of the Virgin Islands of 1954 [48 U.S.C. § 1642] provides that all persons who are permanent residents (inhabitants) of the USVI shall satisfy their income tax obligations under applicable taxing statutes of the United States by paying their tax on income from all sources into the treasury of the USVI. The term "inhabitants" includes corporations as well as natural persons. [*Vitco Inc. v. the Government of the V.I.*, supra, citing *Chicago Bridge & Iron Co. v.*

Wheatley, 295 F. Supp. 240 (D.V.I. 1969), 430 F.2d 973 (3rd Cir. 1970), cert. denied, 401 U.S. 910 (1971)].

A U.S. domestic corporation can be resident in the USVI within the meaning of § 28(a) [Rev. Rul. 80-40] and such corporation is a "foreign" corporation in the USVI [Rev. Rul. 56-616]. Revenue Ruling 80-40 holds, however, that the USVI is to collect income taxes on the worldwide income of its inhabitants, including U.S. domestic corporations resident therein. As set forth in our September 25, 1981 opinion letter, we disagree with that ruling and do not believe it to accurately reflect the law.

Permanent residence, for individuals, is determined annually on the last day of the taxpayer's taxable year. Although no specific ruling exists with respect to corporations, there is nothing to distinguish it as a "person" and its permanent residence should also be determined on the last day of its taxable year. United States filing obligations are also satisfied by such persons filing solely with the USVI government. [Rev. Rul. 60-291, 1960-2 C.B. 407.]

Section 7651(5)(B) provides that § 28(a) of the Revised Organic Act of the Virgin Islands shall be effective as if such section had been enacted subsequent to the enactment of the Internal Revenue Code. Each time the Internal Revenue Code is amended, it is deemed to have been re-enacted in its entirety in its amended form and § 28(a) of the Revised Organic Act is deemed to have been enacted thereafter.

FIRPTA AND THE USVI.

The Foreign Investment in Real Property Tax Act of 1980 provides that sales of United States Real Property Interests by foreign persons shall be taxed as if effectively connected with the conduct of a U.S. trade or business and applies to all dispositions of U.S. real property interests after June 18, 1980 [Section 897]. The effect of the

Act is to tax foreign corporations and nonresident aliens on the disposition of U.S. real estate, usually at capital gains rates.

The Economic Recovery Tax Act of 1981 amended § 897(c) to define U.S. real property interests to include real property interests situated in the USVI. The effect of the amendment (as mirrored as the USVI income tax law) is to make gains from the disposition of U.S. real property interests "effectively connected" with the conduct of a USVI trade or business and to make gains from the disposition of USVI real property interests effectively connected with a U.S. trade or business. Section 6039C was also amended to provide that a nonresident alien individual or foreign corporation subject to tax under section 897(a) shall *pay any tax and file any return required by the Internal Revenue Code* to the United States if the § 897 real property interest is located in the United States and to the USVI if the § 897 real property interest is located in the USVI.

In a discussion with one Karla Hoff of the United States Treasury Department's Office of International Tax Counsel, Miss Hoff agreed with the undersigned that by virtue of § 7651(5)(B), § 28(a) of the Revised Organic Act is controlling over § 6039C(f) and that a resident of the USVI need not file income tax returns with the United States.

DISCUSSION

United States Reporting Requirements

Gains on the disposition of United States real property interests by corporations foreign to the USVI (including U.S. corporations) are now deemed to be effectively connected with the conduct of a USVI trade or business whether or not the corporation is resident in the USVI and without regard to its having any nexus whatsoever with the USVI. If, however, the real property interest is situated in the United States, § 6039C(f) provides

that the foreign taxpayer shall file any return with and pay any tax *required by the Internal Revenue Code* to the United States. Thus, § 897 imposes a *USVI tax* on dispositions of U.S. Real Property Interests which tax, pursuant to § 6039C(f), is to be paid into the Treasury of the United States. Section 6039C(f) also demands that *all* income taxes otherwise due to the USVI shall be paid to the United States if the foreign corporation disposes of any U.S. situs real property interests during the taxable year.

The "dual tax" theory (which has been consistently upheld by the courts) provides that the U.S. and the USVI are separate and distinct tax jurisdictions each using a tax law similar in all respects to that of the other. When Congress passes a tax law for the United States it also passes a separate but similar tax law for the USVI, i.e. two taxes spring to life; that of the United States and that of the USVI. By providing that USRPI's include USVI real property interests and that USVIRPI's include U.S. real property interests, two taxes have been imposed on gains from dispositions of real property interests situated in either of the two separate tax jurisdictions.

Therefore, the threshold question to any analysis of the FIRPTA provisions is the determination of whether the tax imposed is that of the U.S. or that of the USVI. Both taxes must be considered and if a tax is imposed by either or both jurisdictions, one must determine how, if at all, that liability is to be reported and paid in accord with 6039C(f). The §6039C(f) provision, however, seeks to solve the double taxation problem as if a single tax existed and that it need only be apportioned to one jurisdiction or the other.

Under the United States Internal Revenue Code, La Isla Virgen is a domestic corporation, thus not subject to income tax under § 897 which applies only to foreign taxpayers. It necessarily follows that the corporation is

not subject to § 6039C for purposes of United States application of the Code.

IF THE CORPORATION IS REQUIRED TO FILE WITH THE UNITED STATES AT ALL, IT IS BY OPERATION OF THE USVI INCOME TAX STATUTES AND NOT THOSE OF THE UNITED STATES.

It is important to note that § 28(a) does not allocate or divert the United States income taxes to the USVI. Instead, § 28(a) dictates that U.S. income tax obligations are "satisfied" by a USVI inhabitant who files a USVI income tax return and pays the tax thereon to the USVI. Satisfaction of the U.S. income tax obligations does not arise through the reporting and payment provisions of the Internal Revenue Code but rather simply by being subject to the USVI tax laws by reason of being an inhabitant. The tax collected by the USVI is its own tax imposed, collected and administered under its separate and distinct tax laws.

Section 897(a), on the other hand, creates a USVI territorial income tax and § 6039C(f) makes that USVI tax reportable and payable to the United States. The USVI tax must be administered and collected under the USVI income tax laws even though the liability is to the United States. Without more, there is no administrative or jurisdictional authority for the United States to enforce a liability arising under territorial tax laws. Further, the USVI government has no authority under the Code or other law to file deficiency notices, etc. on behalf of the United States Government. If § 6039C(f) imposes a U.S. filing obligation under the USVI tax laws, there is no government body capable of obtaining jurisdiction to enforce such obligation.

Dudley v. Com'r [258 F.2d 182 (3rd Cir. 1958)] holds that the United States Tax Court has no jurisdiction for deficiency notices issued by an officer of the Government of the Virgin Islands nor does that court have jurisdiction over territorial income taxes. Similarly, the

Internal Revenue Service has no authority to issue deficiency notices, impose penalties or interest or otherwise seek to collect such amounts under the provisions of Territorial income tax statutes. A court would first have to find that Congress intended that the United States be some sort of 3rd party beneficiary of the USVI income tax laws. Nothing in the legislative history of FIRPTA or the ERTA amendments indicates any such intention.

More important is the conflict between § 6039C(f) and § 28(a) of the Revised Organic Act. Note that § 6039C (f) does not merely provide that taxes on gains on dispositions of USVI situs real property interests shall be paid to the United States. It provides that the USVI taxpayer "*shall pay any tax and file any return required by this title*" [i.e. Title 26, U.S.Code being the entire Internal Revenue Code] to the United States. Thus, if § 6039C(f) creates a U.S. filing obligation on behalf of a USVI resident, the filing and payment of tax is with respect to the entire taxable income of the taxpayer for that taxable year even if 99.99% of the taxpayer's taxable income is from USVI sources. Here again, the legislative history indicates that Congress intended only to close a loophole which permitted foreign persons to escape tax on dispositions of U.S. real property interests. The Committee reports do not indicate any intention to divert USVI taxes on USVI income to the federal treasury.

Section 28(a) of the Revised Organic Act provides that USVI inhabitants shall satisfy their income tax obligations under applicable taxing statutes of the United States by paying their tax on income derived from all sources both within and outside the USVI into the treasury of the USVI. The provision is mandatory and a USVI inhabitant may not elect to file with the United States as an alternative to filing returns or paying income taxes to the USVI. See *Vitco v. Govt. of V.I.*, 560 F.2d 180 (3rd Cir. 1977), in which the Court held that a USVI corporation cannot satisfy its USVI tax obliga-

tions by filing returns with and paying income taxes to the United States. Section 28(a) also provides that the proceeds of any taxes levied by the Congress on the inhabitants of the USVI shall be covered into the treasury of the USVI.

Section 6039C(f) is obviously in conflict with § 28(a) by requiring a USVI resident to file returns with and pay taxes to the United States. Not only would a USVI inhabitant be required to file with the U.S., but taxes levied by Congress on inhabitants of the USVI would not be covered into the treasury of the USVI.

Generally, where two federal statutes conflict, the last to be enacted governs. Section 7651, however, provides that for purposes of the Internal Revenue Code, § 28(a) shall be effective as if enacted subsequent to the Internal Revenue Code. Thus, it is our opinion that § 28(a) takes precedence over any conflict with § 6039C and that a resident of the USVI need not report gains from dispositions of United States real property interests to the United States.

It is our opinion that La Isla Virgen, Inc. is not subject to reporting to the United States government under the U.S. tax system statutes pursuant to §§ 897 and 6039C because it is a domestic and not a foreign corporation. In light of the ambiguities of § 6039C(f) considered along with its legislative history, we do not believe that Congress created a liability for a U.S. domestic corporation to pay taxes to or file returns with the United States as if the corporation were foreign. It is further our opinion that the United States Treasury has no authority or jurisdiction to issue deficiency notices or bring actions under a Territorial income tax law and that the USVI Government has no authority to issue deficiency notices or bring actions on behalf of the United States Government. Finally, it is our opinion that § 28 (a) of the Revised Organic Act governs over the provisions of § 6039C(f) by virtue of § 7651 which is clear

in its intent that amendments to the Internal Revenue Code will not deprive the USVI of any taxes imposed by Congress on inhabitants of the USVI. Thus under § 28(a), La Isla Virgen, Inc. has no liability to report to or pay income taxes to the United States.

Filing of a United States "Information Return".

Prior to the issuance of Revenue Ruling 80-40, it was not known whether the Internal Revenue Service would recognize that a U.S. domestic corporation could be a resident of the USVI within the meaning of § 28(a) or if they would take the position that a corporation could not migrate from its place of incorporation for purposes of the Internal Revenue Code. To protect against such possibility, we often advised U.S. domestic corporations to file Form 1120 returns with the United States accompanied by a statement that the corporation was resident within the USVI and, pursuant to 28(a), satisfied its U.S. income tax obligations by filing solely with the USVI. Further, the attachment stated that the return was being filed only for information purposes.

The purpose of filing such "information return" was to guard against the imposition of penalties for failure to file and to start the statute of limitations running in the event that it should be held that the corporation could not migrate. Such holding would have the effect of creating a corporate obligation to file with the United States under the U.S. income tax statutes.

Here, the situation is entirely different. The U.S. Internal Revenue Code (as a United States taxing statute) cannot govern the operation of the USVI income tax laws. Since only the USVI statutes could impose an obligation under § 897 to file with the United States, only those laws could commence or toll the running of the statute of limitations for filing or payment of taxes to a "foreign" jurisdiction. If there is any obligation to file with the U.S., it arises from operation of the USVI in-

come tax laws and not those of the United States. The filing of an information return with the United States can in no way commence the running of a United States statute of limitations under the USVI income tax laws. The Code, as mirrored for USVI application, makes no provision for the commencement or tolling of the statute of limitations between any but the USVI government and its taxpayers. Thus, the filing of such return with the U.S. would be fruitless except with respect to the U.S. income tax laws, and there is no § 6039C(f) filing requirement for a domestic corporation.

Such filing would also be meaningless with respect to penalties. There is no provision in the USVI "Internal Revenue Code" for the imposition of penalties by any government except that of the USVI. Unlike § 28(a), one does not "satisfy USVI income tax obligations" by filing returns and paying tax to the United States under § 6039C(f). Instead, § 6039C makes it clear that no obligation to pay income tax or report to the USVI has arisen, in the first instance. It states

". . . (a) foreign corporation subject to tax under section 897(a) shall pay any tax and file any return required by this title—(1) to the United States. . ." If the § 897 real property interest is located in the United States.

There being no income tax obligation due to the USVI to be satisfied, the USVI cannot impose penalties for failure to file a return.

It is, therefore, our opinion that the filing of a U.S. information return would be an exercise in futility which could have no benefits to the corporation and could harbor adverse results in attracting the attention of the Service.

USVI Taxation of Foreign Corporation's Dispositions of U.S. Situs Real Property Interests.

The past and present activities of the corporations and the place of its management and control leave little ques-

tion in our mind but that the corporation is a bona fide inhabitant of the USVI within the meaning of § 28(a). The provision that such inhabitants *shall* satisfy their U.S. income obligations solely by paying their taxes to the USVI is mandatory and not permissive. Notwithstanding § 6039C(f) which requires that the corporation pay any tax and file any returns required by Title 28 of the Internal Revenue Code with the United States, we believe that failure to file the returns with the USVI is in violation of the income tax laws of the USVI as enacted by the Naval Appropriations Act and in violation of § 28(a). Such violations could lead to criminal and civil penalties.

It is, nevertheless, our opinion that the effect of § 897 is to dictate that gains from dispositions of U.S. situs real property interests, after June 18, 1980, are effectively connected with the conduct of a USVI trade or business. A U.S. domestic corporation (or for that matter any corporation foreign to the USVI or nonresident alien individual including U.S. residents), having made such disposition, generally would be required to file a return with the USVI and pay tax thereon. Neither § 897 nor 6039C distinguish between resident and nonresident foreign corporations and residence is not a factor except with respect to § 28(a).

A foreign corporation is required to include in gross income, all income effectively connected with a USVI trade or business [§ 882(b)] unless some other provision of the law excludes that income. Section 6039C(f) provides such exclusion by making it clear that the USVI is to receive payment of taxes only on dispositions of real property interests located in the USVI. Therefore, a foreign corporation or U.S. domestic corporation need not report gains from dispositions of U.S. situs real property interests to the USVI. That is especially true of a U.S. domestic corporation, even if resident in the USVI. Although it satisfies its U.S. income tax obligations by filing with

the USVI, the U.S. domestic corporation has no U.S. income tax obligations pursuant to § 897.

It might be argued that § 6039C(f) is intended only to direct the tax on dispositions of U.S. and USVI real estate to one government or the other; that if § 28(a) prevails over § 6039C, then the § 897 tax is still due on dispositions of U.S. situs real estate to the USVI government because the gain is effectively connected with the conduct of a USVI trade or business. We do not believe that premise to follow. As emphasized above, two taxes, not one, are addressed by § 6039C; that of the U.S. and that of the USVI. The U.S. tax is not relevant to USVI inhabitants since § 28(a) grants the equivalent of an exemption. It must also be presumed that § 6039C(f) is a prohibition against the USVI collecting taxes (either from residents or nonresidents) pursuant to § 897 on U.S. situs real estate.

There is nothing in either § 897 or § 6039C to distinguish between a foreign person resident in the USVI and a nonresident thereof. Thus, if a foreign person resident in the USVI is to pay tax to the USVI by reason of gains on the sale of U.S. situs real estate being effectively connected with the conduct of a USVI trade or business, it follows that nonresidents also must report and pay taxes to the USVI under the same circumstances. Clearly, Congress intended that the USVI be not the benefactor of taxes on gains from dispositions of U.S. situs Real Property Interests pursuant to § 897 and that § 6039C(f) is an absolute prohibition against such taxes being paid into the USVI treasury.

Thus, it is our opinion that a U.S. domestic corporation resident in the USVI need not file a return or pay taxes to the USVI with respect to dispositions of U.S. situs real property interests by virtue of the dictates of § 6039C. Further, by reflecting gains from dispositions of U.S. situs real property interests in the reconciliation of income per books with that reported on the return (schedule M-1 of

form 1120F), we believe sufficient disclosure has been made to the USVI government to apprise it of the fact that income which the taxpayer believes nontaxable has been earned by the corporation and that no penalties or other claims may be made against the corporation for negligence or failure to report.

Interest and Royalty Income.

Revenue Ruling 80-40 states that the USVI is to tax a resident U.S. corporation as if it were domestic to the USVI, i.e., on its worldwide income. We disagree with that interpretation of § 28(a) and the mirrored application of the Internal Revenue Code as a separate and distinct territorial income tax statute. See the discussion of that issue in our September 25, 1981 opinion letter.

Assuming that La Isla Virgen, Inc. is to be taxed by the USVI under the usual rules of the Code as a foreign corporation, it is liable to the USVI for taxes only on income which is from USVI sources or effectively connected with the conduct of a USVI trade or business. La Isla Virgen, Inc. has used a part of the proceeds of the redemption of its partnership interest in Pacifica Properties to invest in certificates of deposit (or other forms of interest bearing deposits) with the St. Thomas, USVI branch of Bank of America. The corporation also has royalty income from certain oil properties situated in the continental United States which properties were received as part of the same partnership redemption.

Section 861(a)(1)(A) provides that interest paid to foreign taxpayers on amounts described in § 861(c) is not from USVI sources unless effectively connected with the conduct of a USVI trade or business. Section 861(c) refers to deposits with persons carrying on the banking business. Thus, unless that interest is "effectively connected," La Isla Vergen, Inc. has no tax liability to the USVI on amounts so accrued or received.

Whether such income is "effectively connected" is determined by the "asset use test" and the "business activi-

ties test" as set forth in §§ 864(c)(2)(A) and (B) and the regulations thereunder. Under the first test, income derived from assets used or held for use in the conduct of a USVI trade or business is effectively connected with that trade or business. Here, the funds are not used or held for use in any USVI trade or business. The second test provides that if the activity of the USVI trade or business is a material factor in the realization of the interest income, then the interest will be effectively connected with the trade or business. Isla Virgen's USVI business (office building ownership, management and rental) is in no way a material factor in the realization of the corporation's interest income on investments.

It is, therefore, our opinion that the interest income is neither from USVI sources nor effectively connected with the conduct of a USVI trade or business and such interest need not be reported as taxable income.

Income arising from the rental of real or tangible personal property has its source at the place where the property is located. Income from the use of intangible personal property arises at the place where the intangibles are used. Here the oil properties and any intangible rights attaching thereto are situated in the United States. Thus, rents or royalties derived from these properties are not from USVI sources.

Generally, only USVI source income can be deemed to be effectively connected with a USVI trade or business. Beside the exception for disposition of real estate under the FIRPTA rules discussed above, three exceptions exist. Foreign source income can be "effectively connected" if it consists of:

(1) rents, royalties and gains on the sale of intangibles;

(2) dividends, interest, gains or losses from the sale of securities; or

(3) sales of goods or merchandise

if there is a USVI fixed place of business which is a material factor in the realization of such income.

None of those categories applies to La Isla Virgen unless the oil royalties are deemed to be for the use of intangibles. Even if the royalty income so qualifies, the USVI office did not negotiate the leases or do any other thing causing it to be a "material factor" in the realization of such income. The mere fact that such contracts or leases are subject to the approval of the USVI office does not cause that office to be a material factor in the realization of the income.

It is, therefore, our opinion that La Isla Virgen's royalty income from property located and used outside of the USVI need not be reported as taxable income to the USVI government.

If you have any questions, we shall be pleased to meet with you to discuss the matter at your convenience.

Sincerely,

/s/ Gustav A. Danielson
GUSTAV A. DANIELSON

[Lansdale Letter of 12/16/80]

Mr. William M. Lansdale
Post Office Box 27
Seal Beach, California 90740

December 16, 1980

C. Robert Langslet & Son, Inc.
296 Redondo Avenue
Long Beach, California 90803

RE: Marina Pacifica 1-B

Dear Bob:

This letter is designed to set forth our mutual understanding relating to the acquisition by your company of the asset known as 1-B now owned by Marina Pacifica, and of the limited partner's interest which, although in my name alone, is the community property of Marianthi and William Lansdale.

Marina Pacifica is a Limited Partnership formed in California in 1972 for the purpose of building the Marina Pacifica (Long Beach) project. That project was divided into three parts, identified as 1-A, 1-B and 1-C. 1-A has been completed and sold. 1-C, the commercial part of the package, has also been completed and sold. 1-B has not been started, although the channel that is an integral part of the development has been completed or will be by March 1981.

1-B has been engineered and approved for 453 single family condominium style residences and 250 boat slips. Based upon our discussion, you have offered on this date to acquire the general partner's undivided interest in Marina Pacifica. I am the only other partner in Marina Pacifica. This letter is designed to record our agreement regarding the acquisition of my partnership interest.

SCFC, through Dr. Frank Moothart, has indicated his agreement to sell the partnership's interest in 1-B for

forty million dollars to another builder. Although I have not given my consent to that proposal, I have told Dr. Moothart that I believe the value of my interest in 1-B is six million dollars of the total of forty. If, however, your proposal is accepted by Dr. Moothart and SCFC, then I am prepared to divide with him the forty million on the basis of about 36 to 4, provided that he concurrently causes Marina Pacifica to distribute my interests in the boat slips and the net assignment fee income (frequently referred to as the "sandwich position").

Although I am still working out the details with Dr. Moothart, it appears that he will be willing to assign to me some cash that SCFC would otherwise receive and a portion of your promissory note. In order to facilitate matters, we will propose to him that your firm simply net against the forty million whatever cash and note portion he has agreed to pay to me.

In order to obtain my agreement to divide the proceeds with Dr. Moothart, you in turn have agreed to use every best effort to obtain the 1-B portion of the project either by becoming the general partner (our first preference) or by acquiring some other interest in the project, either directly or indirectly, through a related company.

Upon your company, or one with which you are related, directly or indirectly, obtaining that interest, you and I agree that we will form a partnership and you will cause that partnership to acquire the interest in 1-B and to thereafter redeem my interest (except for a remaining one percent) by issuing to me a distribution in partial liquidation of my interest as follows:

> (a) All oil and gas or other hydrocarbon interests now owned or used by Marina Pacifica, including assignments or all legal rights (easements, division orders, property rights, etc.) all personal property (machinery, equipment, supplies used in the oil and gas aspects of the business) and all reserves.

(b) Eight million dollars in cash reduced by the amount of cash paid to SCFC for its interest or paid to Marina Pacifica. That payment to SCFC or Marina Pacifica in any event will not exceed $7.5 million.

(c) A promissory note in the amount calculated by reducing the sum of $36.5 million by the face amount of the note given to SCFC or Marina Pacifica by you. The note to me will not be less than four million dollars. It will carry 10% interest payable over four years, annually. (As a matter of courtesy to me, you have agreed to consider issuing a series of notes, five for $100,000 each, and the rest in $500,000 denominations. All will carry identical terms.) All notes are to be unconditionally guaranteed by Crocker National Bank.

I plan to close the transaction with you shortly after your closing with SCFC, but in no event later than ten business days thereafter.

Prior to the closing, our counsel will prepare a definitive agreement that contains some rather simple representations concerning our title to the partnership interest which, of course, must be lien free.

Turning to the one percent remaining interest, I believe it to be in your best interests to have me remain with an interest in the project. We hope my continuing interest will encourage you to consult with me and that I will take a continuing interest in the project's growth. I would be paid for my time as a consultant. You shall be able to redeem my one percent interest at your election. Hence, I agree to let you acquire the remaining one percent for a price of $500,000, plus a continuing value increase factor of 1.5% per month.

If the foregoing sets forth the essence of our understanding, please sign a copy of this letter and return it to me.

Yours truly,

/s/ William M. Lansdale
WILLIAM M. LANSDALE

The foregoing sets forth our agreement.

Dated: December 16, 1980

C. ROBERT LANGSLET & SON, INC.

By /s/ CRL
C. ROBERT LANGSLET
President

[Lansdale Letter of 1/15/81]

January 15, 1981

Rufus v. Rhoades, Esq.
73-255 El Paseo, Suite 14
Palm Desert, California 92260

Dear Rufus:

We hereby enclose the Power of Attorney which we have discussed over the last few weeks. We are giving it to you in order to allow you to sign on our behalf the documents relating to the winding up of Marina Pacifica and the Langslet acquisition of most of our interest in I-B, if they are finalized during our absence.

You have drawn the power according to our instructions which were particularly limited. Although we are prepared to allow Crocker Bank to have a security interest in the oil interests which are to be assigned to us, we would really much rather avoid that if possible. Nevertheless, if the deal is about to break apart unless you are able to deliver a security interest go ahead and sign on our behalf whatever Crocker Bank requires on that issue but only if we are entitled to continue to receive all of the income. We don't want the income stream escrowed or otherwise tampered with; that is to be exclusively ours with no strings.

Otherwise, we do not want you to sign any papers unless the deal is substantially similar to the one that we have already made with Langslet and with Moothart. Obviously, you can tinker with the documents if there are no changes which you in your judgment consider to be material.

Finally, if you do close while we are gone (which I doubt) then please take the funds and immediately invest them in Fed Funds. We would like them to mature within a week of our return (presently scheduled for February

12) but within that limit go ahead and get us as high a yield as you can from either Fed Funds or short term banking paper.

We have also enclosed our itenerary in the event that you need to reach us for some major decision while we are gone.

Best regards,

/s/ William M. Lansdale
WILLIAM M. LANSDALE

/s/ Marianthi Lansdale
MARIANTHI LANSDALE

RECORDING REQUESTED BY

Rufus v. Rhoades

WHEN RECORDED MAIL TO

Rufus v. Rhoades
73-255 El Paseo, Suite 14
Palm Desert, Calif. 92260

POWER OF ATTORNEY

KNOW ALL MEN BY THESE PRESENTS: That we, WILLIAM M. LANSDALE and MARIANTHI K. LANSDALE, the undersigned (jointly and severally, if more than one) hereby make, constitute and appoint Rufus v. Rhoades of Palm Desert, California our true and lawful attorney for us and in our name, place and stead and for our use and benefit, jointly and severally

1. To execute any and all agreements, papers, notices, claims, instructions, checks or other documents relating to or in any manner connected with

(a) our interest in a partnership formed by C. Robert Langslet & Son, Inc. as general partner and William M. Lansdale (acting for both of us) as limited partner, which partnership we have called "Pacifica Properties";

(b) our interest in Marina Pacifica, a California limited partnership of which William M. Lansdale is a named limited partner and any assets thereof in which we have an interest

whether such documents provide for the sale, dissolution, distribution, contribution or any other event or transaction *provided, however*, that (i) as to any document providing for the distribution of any property to us by Marina Pacifica such transfer shall include

(A) the entire interest of Marina Pacifica in and to the Boating Facilities Lease and all related boating facilities as described in the Certificate and Agreement of Limited Partnership of Marina Pacifica, the latest amendment of which was recorded on March 22, 1978, Document No. 78-301209 in the Official Records, Los Angeles County Recorder's Office, California, and

(B) 43.75 percent of the Assignment Fee Income from that portion of the property owned by Marina Pacifica generally known as I-A

free of any lien, encumbrance or claims of others, all without cost or charge to us except closing costs, if any, and (ii) as to any transaction with C. Robert Langslet & Son, Inc. company, such agreements and documents shall reflect the terms of the letter agreement entered into by us and that company on December 16, 1980, a copy of which is attached hereto as Exhibit A.

2. To receive on our behalf all checks, notes, documents and other papers that are to be delivered to us to close the transactions described above.

3. To deposit all checks in any major banks through the trust account of Rufus v. Rhoades, a Law Corporation, for investment in short term income producing obligations of that bank or the Federal government or any agency thereof.

4. To sign our names as attorney in fact in order to accomplish the foregoing transactions but for no other.

GIVING AND GRANTING unto my said Attorney full power and authority to do and perform all and every act and thing whatsoever requisite, necessary or appropriate to be done in and about the premises as fully to all intents and purposes as we might or could do if personally present, hereby ratifying all that our said Attorney shall lawfully do or cause to be done by virtue of these presents.

Our said Attorney is empowered hereby to determine in his sole discretion the time when, purpose for and manner in which any power herein conferred upon him shall be exercised, and the conditions, provisions and covenants of any instrument or document which may be executed by him pursuant hereto to the extent they do not violate the limitations and requirements herein set forth.

Marianthi V. Lansdale as a married woman, hereby further authorizes and empowers my said Attorney, as my duly authorized agent, to join in my behalf, in the execution of any instrument by which any community real property or any interest therein, now owned or hereafter acquired by me is sold, leased, encumbered, or conveyed.

When the context so requires, the masculine gender includes the feminine and/or neuter, and the singular number includes the plural.

WITNESS my hand this 15th day of January, 1981.

/s/ William M. Lansdale
WILLIAM M. LANSDALE

/s/ Marianthi K. Lansdale
MARIANTHI K. LANSDALE

STATE OF CALIFORNIA)
) ss.
COUNTY OF LOS ANGELES)

On , 1981, before me, the undersigned, a Notary Public in and for said State, personally appeared WILLIAM M. LANSDALE and MARIANTHI K. LANSDALE, known to me to be the persons whose names are subscribed to the within instrument and acknowledged that they executed the same.

WITNESS my hand and official seal.

Signature _____

[SEAL]

NOTICE OF ASSIGNMENT

TO: Marina Pacifica, a limited Partnership

FROM: William M. Lansdale

DATE: March 11, 1981

Please take notice that the undersigned has this date assigned to La Isla Virgen, Inc., 22 Crystal Gade, St. Thomas, U.S. Virgin Islands 00801, all of the rights of the undersigned to receive distributions from Marina Pacifica to the extent such rights relate to the parcel generally known as "Marina Pacifica I-B." A true copy of such assignment is attached hereto. The undersigned does not intend to transfer his status as a limited partner to the transferee but merely his contribution rights.

Please acknowledge and consent to said assignment on the copies of this Notice supplied herewith and return such copies to the undersigned.

/s/ William M. Lansdale
WILLIAM M. LANSDALE as a
Limited Partner of
Marina Pacifica

The assignment set forth above is hereby acknowledged.

Dated: March 11, 1981

MARINA PACIFICA
by Southern California
Financial Corp.
General Partner

By _____

ASSIGNMENT OF INTEREST

AS A CAPITAL CONTRIBUTION the undersigned hereby assigns, transfers and sets over to La Isla Virgen, Inc., a Delaware corporation, (1) his right to receive any and all distributions whether in the nature of cash, property or otherwise, from and as a limited partner of Marina Pacifica, a California limited partnership, to the extent that such interest relates to a ground lease, oil and gas leases and oil and gas improvements covering or located on a parcel of real estate located in Long Beach, California, the legal description of which is:

> Lots 1 through 8 inclusive, 12, and 14 through 27 inclusive, of Tract No. 36414 as shown in the Map recorded in Book 966, Pages 54 through 63, inclusive of Maps, Official Records of the County Recorder of the County of Los Angeles, State of California.

and commonly known as "Marina Pacifica I-B," and (2) any and all rights the undersigned may have under the letter agreement dated December 16, 1980 with C. Robert Langslet & Son, Inc.

This assignment is limited in the following respects:

(1) it does not include any interests to which Lansdale is entitled with respect to that certain Boating Facilities Lease between Marina Pacifica as lessee and Security Pacific National Bank as trustee under the Will of Warren F. McGrath as lessor;

(2) it does not include any interest to which Lansdale is entitled with respect to the Agreement Concerning Collection of Rents and Assignment Fees, Assignment of Assignment Fees and Granting of Security Interest between Marina Pacifica and the said Security Pacific National Bank as Trustee;

(3) it does not include the status of Lansdale as a Limited Partner in Marina Pacifica, the intention of Lansdale being to assign certain distribution rights but

not to allow La Isla Virgen to become or assume the status of a Substituted Limited Partner.

Lansdale shall promptly give notice of this Assignment to Marina Pacifica with the request that Marina Pacifica acknowledge and consent to this Assignment.

Dated: March 11, 1981.

WILLIAM M. LANSDALE

As the wife of William M. Lansdale, I hereby consent to the foregoing Assignment.

Dated: February 11, 1981.

MARIANTHI LANSDALE

ASSIGNMENT OF INTEREST

AS A CAPITAL CONTRIBUTION the undersigned hereby assigns, transfers and sets over to Pacifica Properties, a California limited partnership, its right to receive any and all distributions, whether in the nature of cash, property or otherwise, from Marina Pacifica, also a California limited partnership, to the extent that such interest relates to a ground lease, oil and gas leases and oil and gas improvements covering or located on a parcel of real estate located in Long Beach, California, the legal description of which is:

> Lots 1 through 8 inclusive, 12 and 14 through 27 inclusive, of Tract No. 36414 as shown in the Map recorded in Book 966, Pages 54 through 63, inclusive of Maps, Official Records of the County Recorder of the Company of Los Angeles, State of California.

and commonly known as "Marina Pacifica I-B."

This assignment is limited to but is also co-terminus with the assignment dated February 11, 1981 received from William M. Lansdale a copy of which is attached hereto for reference.

La Isla Virgen shall promptly give notice of this Assignment to Marina Pacifica with the request that Marina Pacifica acknowledge and consent to this Assignment.

Dated: March , 1981.

LA ISLA VIRGEN, INC.

By _____

, President

22 Crystal Gade
St. Thomas, U.S. Virgin Islands 00801

No. 91-1822

Supreme Court, U.S.
FILED
JUN 18 1992
OFFICE OF THE CLERK

IN THE

Supreme Court of the United States

OCTOBER TERM, 1991

LA ISLA VIRGEN, INC.,

Petitioner,

v.

ANTHONY P. OLIVE, Director of Virgin Islands Bureau of Internal Revenue, and GOVERNMENT OF THE VIRGIN ISLANDS,

Respondents.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Third Circuit

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BRIEF IN OPPOSITION

ROSALIE SIMMONDS-BALLENTINE
Attorney General

ROY E. PARROTT
Solicitor General

JOSEPH M. ERWIN
Assistant Attorney General (Tax)
Department of Justice
Government of the Virgin Islands
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QUESTIONS PRESENTED

1. Whether the courts below correctly determined that Petitioner did not meet its burden of proving that it should not be subject to negligence penalties.

2. Whether the penalty for substantial underpayment of income taxes provided in section 6661 of the Internal Revenue Code may be imposed on a United States person that resides in the United States Virgin Islands.

3. Whether sections 1277(c)(2)(B)(ii) and 1277(c)(2)(E) of the Tax Reform Act of 1986 prevent the Virgin Islands from taxing Petitioner on certain income that is exempt from United States tax under section 1277(c)(2)(E) of such Act.

4. Whether the district court below erred in its determination that a certain sale of property occurred after the property was transferred to Petitioner and that Petitioner was therefore taxable on the gain from the sale.

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1991

No. 91-1822

LA ISLA VIRGEN, INC.

Petitioner,

v.

ANTHONY P. OLIVE, Director of Virgin Islands Bureau of Internal Revenue, and GOVERNMENT OF THE VIRGIN ISLANDS,

Respondents.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Third Circuit

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BRIEF IN OPPOSITION

Respondents, Anthony P. Olive, Director of the Virgin Islands Bureau of Internal Revenue (hereinafter, "the VIBIR"),[1] and the Government of the Virgin Islands, oppose the Petition for a Writ of Certiorari. The Petition raises no issue worthy of review by this Court.

Respondents do not challenge Petitioner's assertions under the headings Opinions Below, Jurisdiction,

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[1] Anthony P. Olive has been succeeded in office by Edward E. Thomas.

and Statutes Involved. Respondents do challenge portions of Petitioner's Statement of the Case. Therefore, Respondents submit their own Statement of the Case.

STATEMENT OF THE CASE

Respondents generally agree with the facts set forth in Petitioner's Statement of the Case.[2] Respondents believe, however, that the Court would benefit from a more detailed explanation of the legal context in which this case arises than is provided in Petitioner's Statement. Respondents also believe that Petitioner has misstated certain facts relating to its alleged reliance on counsel. Accordingly, this statement is provided.

Petitioner was incorporated in the State of Delaware on March 6, 1981, by William M. Lansdale (hereinafter, "Lansdale"), a United States individual.[3] (Pet. 3.[4]) Although Petitioner has conducted some business in the Virgin Islands (Pet. App. 60a), most of Petitioner's income for the years in issue (Petitioner's taxable years ended February 28, 1982, February 28,

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[2] The factual portion of Petitioner's Statement of the Case begins on the top of page three of the Petition and ends with the first full paragraph on page six of the Petition.

[3] Petitioner's capital stock actually was issued to William M. Lansdale and Marianthi K. Lansdale, husband and wife, as community property. (Pet. 4, n.1.) Throughout this brief, references to "Lansdale" are intended to include both William and Marianthi Lansdale, when appropriate.

[4] "Pet." references are to the Petition for a Writ of Certiorari. "Pet. App." references are to the Appendix to the Petition. "Resp. App." references are to the Appendix to this Brief in Opposition.

1983, February 29, 1984, February 28, 1985, and February 28, 1986) consisted of gains from sales of property located in the mainland United States. During the years in issue, Petitioner reported approximately $19.97 million of income from non-Virgin Islands sources (most of which was attributable to sales of property located in the United States). (Pet. App. 18a-19a.)

At the time Petitioner filed its income tax returns for the years in issue, a United States corporation doing business in the Virgin Islands (such as Petitioner) was obligated to pay taxes into the Virgin Islands treasury pursuant to two statutes.

The first statute was § 1 of the Naval Service Appropriation Act, 1922, Act of July 12, 1921, ch. 44, § 1, 42 Stat. 123 (1921) (codified, as amended, at 48 U.S.C.S. § 1397 (Law. Co-op. 1981 & Supp. 1989)),[5] which established the "mirror" tax system. Under the mirror system, the U.S. Internal Revenue Code (hereinafter, the "I.R.C.") is applied in the Virgin Islands in "mirrored" form (hereinafter, the "mirror code") by substituting the words "Virgin Islands" for the words "United States". *E.g., Vitco, Inc. v. Government of the Virgin Islands*, 560 F.2d 180, 180-82 (3d Cir. 1977), *cert. denied*, 435 U.S. 980 (1978). Under the mirror code, Petitioner was treated as a foreign corporation and was obligated to pay taxes to the Virgin Islands on its Virgin Islands source income and its income that was effectively connected with a Virgin Islands trade or business. I.R.C. §§ 881 and 882 (mirrored).

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[5] References to § 1 of the Naval Service Appropriation Act are to such section as in effect for the years in issue.

The second statute was § 28(a) of the Revised Organic Act of the Virgin Islands, Act of July 22, 1954, ch. 558, § 28(a), 68 Stat. 508, (codified, as amended, at 48 U.S.C.S. § 1642 (Law. Co-op. 1981 & Supp. 1989)) (hereinafter, "ROA § 28(a)" or "the inhabitant rule").[6] ROA § 28(a) directed a U.S. corporation qualifying as an "inhabitant" of the Virgin Islands to satisfy its U.S. income tax obligations by paying its tax under the I.R.C. to the Virgin Islands. ROA § 28(a) provided, in pertinent part:

> [T]he term "inhabitants of the Virgin Islands" as used in this section shall include all persons whose permanent residence is in the Virgin Islands, and *such persons shall satisfy their income tax obligations under applicable taxing statutes of the United States by paying their tax on income derived from all sources both within and outside the Virgin Islands into the treasury of the Virgin Islands*. . . .

ROA § 28(a) (emphasis added). The parties agree that, for the years in issue, Petitioner was an "inhabitant" of the Virgin Islands within the meaning of ROA § 28(a). (Pet. 3; Pet. App. 16a.)

At the time Petitioner filed its returns for the years in issue, the effect of the inhabitant rule was the subject of differing interpretations. According to a "tax haven theory" propounded in the Tax Management, Inc., portfolio *Business Operations in the U.S. Virgin Islands*, authored by Virgin Islands lawyer/

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[6] References to § 28(a) of the Revised Organic Act of the Virgin Islands are to such section as in effect for the taxable years in issue.

accountant Gustav A. Danielson ("Danielson"), the inhabitant rule permitted a U.S. corporation that qualified as a Virgin Islands inhabitant to avoid paying *any* tax, to either the United States or the Virgin Islands, on its non-Virgin Islands source income that was not effectively connected with a Virgin Islands trade or business.[7]

The VIBIR and the Internal Revenue Service, on the other hand, took the position that the inhabitant rule required such a corporation to pay to the Virgin Islands the same tax it would pay if it were a domestic Virgin Islands corporation.[8]

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[7] Danielson, 336-2nd T.M., *Business Operations in the U.S. Virgin Islands* (1985). The theory was based on the following two arguments (*see Bizcap, Inc. v. Olive*, 892 F.2d 1163, 1166 (3d Cir. 1989), *cert. denied sub nom. Caribbean Marine, Inc. v. Olive*, 496 U.S. 905 (1990)):

1. Under the inhabitant rule, a U.S. corporation qualifying as a Virgin Islands inhabitant satisfied its entire U.S. income tax obligation simply by filing a tax return with the Virgin Islands and paying to the Virgin Islands the corporation's tax *as determined under the mirror code*.

2. Under the mirror code, a U.S. corporation was not subject to Virgin Islands tax on non-Virgin Islands source income unless that income was effectively connected with a Virgin Islands trade or business because, for mirror-code purposes, a U.S. corporation was a "foreign corporation." I.R.C. §§ 881 and 882 (mirrored).

In *Danbury, Inc. v. Olive*, 820 F.2d 618, 625 (3d Cir. 1987), *cert. denied*, 484 U.S. 964 (1987), the Third Circuit pointed out that Danielson's Tax Management Portfolio (at p. A-91) described this interpretation of the inhabitant rule as a "tax haven theory."

[8] *See Danbury*, 820 F.2d at 620 (setting forth the VIBIR's position), and Rev. Rul. 80-40, 1980-1 C.B. 175 (setting forth the Internal Revenue Service's position).

Petitioner filed its returns for 1982-86 on the basis of Danielson's tax haven theory. It reported non-Virgin Islands source income of nearly $20 million for this period but paid no tax on that income. (Pet. App. 18a-19a.)

On May 13, 1986, following examinations of Petitioner's 1982 and 1983 returns, the VIBIR issued to Petitioner the first of a series of statutory notices asserting tax deficiencies and penalties. For the period 1982-1986, the asserted deficiencies and penalties totaled $8,729,927 and $1,991,154, respectively. (Pet. 3; Pet. App. 16a.)

On October 22, 1986, Congress repealed the inhabitant rule by enacting § 1275(b) of the Tax Reform Act of 1986 (hereinafter, "TRA 86"), Pub. L. 99-514, § 1275(b), 100 Stat. 2085, 2598 (1986) (codified at I.R.C. § 7651(5)(B) (CCH 1991). Under the new law, "a corporation such as Danbury [*i.e.*, a U.S. corporation qualifying as a Virgin Islands inhabitant] pays its taxes under the mirrored Code to [the VIBIR] and pays its taxes under the [I.R.C.] to the Internal Revenue Service." *Danbury, Inc. v. Olive*, 820 F.2d 618, 625 (3d Cir. 1987), *cert. denied*, 484 U.S. 964 (1987).

The generally applicable effective-date provision, TRA 86 § 1277(c)(2), 100 Stat. 2601, made the repeal both prospective (*i.e.*, applicable to taxable years beginning after 1986) and partially retroactive (*i.e.*, applicable to certain taxable years beginning before 1987, referred to in the statute as "pre-1987 open years"). Petitioner, however, received a "targeted" exception (*i.e.*, an exception applying only to Petitioner) from the retroactive application of the repeal of the inhabitant rule, through TRA 86

§ 1277(c)(2)(E), 100 Stat. 2601. (Pet. App. 32a.) Petitioner's exception states:

> (E) EXCEPTION FOR CERTAIN TRANSACTIONS.
>
> (i) IN GENERAL. In the case of any pre-1987 open year, the amendment made by section 1275(b) shall not apply to [certain income derived by Petitioner].[9]

On June 5, 1987, the United States Court of Appeals for the Third Circuit decided *Danbury*, 820 F.2d 618, rejecting Danielson's tax haven theory and holding that, under the plain language of the inhabitant rule (as in effect prior to its repeal)—

> Danbury owed the [VIBIR] (1) Virgin Islands taxes on Virgin Islands-generated income, under the Naval Appropriations Act [*i.e.*, the mirror code], and (2) U.S. taxes on worldwide income, figured with a tax credit for any Virgin Islands or other foreign taxes paid, under Section 28(a).

Danbury, 820 F.2d at 623.

On July 21, 1986, January 11, 1988, and August 5, 1988, Petitioner filed petitions in the District Court

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[9] The exception does not actually refer to Petitioner by name, but refers to "any income derived from transactions described in clause (ii) by 1 or more corporations which were formed in Delaware on or about March 6, 1981, and which have owned 1 or more office buildings in St. Thomas, United States Virgin Islands, for at least 5 years before the date of the enactment of this Act." TRA 86 § 1277(c)(2)(E)(i), 100 Stat. 2601. The parties agree that this language refers to Petitioner and that the "transactions described in clause (ii)" are the transactions at issue in this case. (Pet. App. 32a.)

of the Virgin Islands for redetermination of the tax deficiencies asserted against it by the VIBIR. (Pet. 3.) The district court consolidated the actions by Order dated April 12, 1990.

In view of the Third Circuit Court of Appeals' holding in *Danbury*, Petitioner did not argue in the proceedings below that Petitioner's non-Virgin Islands source income was exempt from Virgin Islands taxation by reason of ROA § 28(a). (*I.e.*, Petitioner did not argue that Danielson's tax haven theory was correct.) Instead, Petitioner argued that such income was exempt from Virgin Islands taxation by reason of TRA 86 § 1277(c)(2)(E), Petitioner's targeted exception to the retroactive repeal of the inhabitant rule. (Pet. App. 8a.) Petitioner also argued, inconsistently with the form of its transactions and its reporting of those transactions, that certain of the income did not belong to Petitioner. (Pet. 22.)

The district court below, relying on *Bizcap, Inc. v. Olive*, 892 F.2d 1163 (3d Cir. 1989), *cert. denied sub nom. Caribbean Marine, Inc. v. Olive*, 496 U.S. 905 (1990), rejected Petitioner's argument and held that (i) TRA § 1277(c)(2)(E) simply treated Petitioner, for the taxable years in issue, as though the inhabitant rule had not been repealed, and (ii) under the court of appeals' holding in *Danbury*, the inhabitant rule required Petitioner to pay tax to the Virgin Islands on Petitioner's income from all sources.[10] (Pet. App.

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[10] In *Bizcap*, 892 F.2d 1163, the Third Circuit Court of Appeals had reached the identical conclusion with respect to another corporation, which was the beneficiary of another targeted exception to the retroactive repeal of the inhabitant rule, set forth in TRA 86 § 1277(c)(2)(D), 100 Stat. 2601.

5a-8a.) The district court observed that the drafters of TRA 86 § 1277(c)(2)(E) could have stated explicitly that Petitioner was exempt from tax liability on its U.S. source income for the years in issue, but did not do so. (Pet. App. 8a.)

The district court also rejected Petitioner's argument that certain of the income Petitioner had reported did not belong to Petitioner. (Pet. App. 9a.)

Finally, the district court sustained the penalties imposed on Petitioner by the VIBIR under I.R.C. §§ 6651(a) (relating to failure to file a timely return), 6653(a) (relating to negligence or disregard of rules and regulations), and 6661(a) (relating to substantial understatement of income tax). With respect to the negligence penalty, Petitioner had taken the position that "it was not negligent because it relied on advice of its legal counsel in determining its tax liability." (Pet. App. 10a.) Respondents, on the other hand, had argued that Petitioner had not produced evidence that it *reasonably* relied on competent counsel, pointing out that Petitioner had "sought the opinion of the author of the '28(a) tax haven theory' whose advice and predisposition were known from the 'portfolio.' " (Resp. App. 6a.) The district court made no finding that Petitioner had reasonably relied on counsel in determining its tax liability,[11] noted that "the tax-

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[11] The Petition erroneously refers to "the stipulation that [Petitioner] relied on advice of its legal counsel in determining its tax liability, which precludes imposition of penalties for negligence." (Pet. 7.) There is no such stipulation in the record. The parties stipulated only that Danielson, who had been retained by Lansdale, analyzed Lansdale's income tax situation, architected the various transactions in issue, and provided two opinion letters, dated September 25, 1981, and June 25, 1982,

payer has the burden of proving the absence of negligence" (Pet. App. 10a), and sustained the penalty.[12]

On December 17, 1991, the Court of Appeals for the Third Circuit affirmed the judgment of the district court, without opinion (Pet. App. 1a),[13] and on January 14, 1992, the Court of Appeals for the Third

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regarding the tax consequences of the transactions. (Pet. App. 34a-35a.) The parties did not, however, stipulate that Petitioner relied on Danielson's advice in determining Petitioner's tax liability. In fact, it is difficult to see how Petitioner could have concluded that it owed no tax to the Virgin Islands on the basis of Danielson's advice, since Danielson's September 25, 1981, letter identified substantial grounds for expecting the Third Circuit to reject the tax haven theory. (*See* Pet. App. 76a-77a.)

Moreover, Rufus Rhoades, Lansdale's regular attorney and a tax expert able to exercise independent judgment, never advised Lansdale or Petitioner that the tax haven theory was correct, but merely "concluded that the . . . theory was sufficiently valid to make it worthwhile pursuing." (Pet. App. 29a.)

Thus, the parties did not stipulate, and the district court did not find, that Petitioner relied on the advice of counsel in determining its tax liability.

[12] Respondents' principal argument in the district court in connection with the I.R.C. § 6653(a) penalty was that Petitioner should be found liable for the penalty because Petitioner intentionally disregarded rules and regulations. (Resp. App. 3a-6a.) The district court, however, stated: "This record does not support a finding of intentional disregard of rules or regulations." (Pet. App. 10a.)

[13] On appeal to the Third Circuit, Respondents requested the court of appeals to reverse the district court's determination that the record did not support a finding of intentional disregard of rules or regulations. (Resp. App. 11a-14a.) Respondents also reiterated their assertion that Petitioner had not proven that it reasonably relied on counsel. (Resp. App. 15a-16a.)

Circuit denied Petitioner's petition for rehearing and for rehearing *en banc*. (Pet. App. 12a-13a.)

This Petition for a Writ of Certiorari followed.

REASONS FOR DENYING THE WRIT

A. The Decision Below Raises No Issue Worthy of Review by This Court

This case involves nothing more than an attempt by William M. Lansdale, a United States individual taxpayer, to avoid paying any tax on United States source income by means of a now-discredited tax-shelter scheme utilizing the so-called tax haven theory of Virgin Islands taxation promoted by lawyer/accountant Gustav Danielson.

The Petition itself reveals that, to implement Danielson's tax haven theory, and utilizing Danielson's services, Lansdale (i) created Petitioner, (ii) transferred to Petitioner an interest in California real estate in a tax-free exchange, (iii) caused Petitioner to dispose of that real estate, and (iv) caused Petitioner to report the resulting gain as tax-free income to the VIBIR, all for the purpose of avoiding tax. (Pet. 4-6; Pet. App. 29a.) Moreover, in furtherance of this tax avoidance plan, (i) Lansdale paid no tax on the gain (Pet. App. 28a), and (ii) relying on the tax haven theory, Petitioner paid no tax on the gain. (Pet. App. 18a-19a.) Then, after the Third Circuit held in *Danbury*, 820 F.2d 618, that the tax haven theory was contrary to the plain language of ROA § 28(a), and after the Third Circuit held in *Bizcap*, 892 F.2d 1163, that the targeted exception in TRA 86 § 1277(c)(2)(D) did not exempt its beneficiary from Virgin Islands taxes, Petitioner attempted to disavow the unambig-

uous and consistently reported form of the transactions at issue (namely, a tax-free contribution of property by Lansdale to Petitioner, followed by a taxable disposition of that property by Petitioner), arguing that Lansdale, and not Petitioner, should have reported, and paid tax on, the gain from those transactions.[14] The courts below properly rejected all of Petitioner's arguments, and there is no basis for this Court to review their decisions.

In its attempt to persuade this Court to review the decisions below, Petitioner vainly seeks to portray this case as something other than a routine tax shelter case.

First, Petitioner attempts to characterize the decisions below as "[resurrecting] a strict liability theory of tax negligence once characterized by the Third Circuit as 'an inconceivable proposition'" (Pet. 12), when in fact the courts below simply held that Petitioner had not met its burden of proving that Petitioner was not negligent.

Second, Petitioner attempts to persuade this Court that the penalty provisions in the I.R.C. do not apply in the Virgin Islands, disregarding all contrary authority and relying solely on Petitioner's novel and preposterous proposition that Congress established a taxing system in the Virgin Islands without *any* procedural and administrative rules. (Pet. 13-14.)

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[14] Under I.R.C. § 6501(a), the statute of limitations for Lansdale's most recent return for the period in issue expired on April 15, 1990, unless Lansdale and the Internal Revenue Service agreed to extend the statute of limitations under I.R.C. § 6501(c)(4). The record does not show that Lansdale and the Internal Revenue Service have entered into such an agreement.

Third, Petitioner argues that the VIBIR has no authority to collect Petitioner's taxes, relying on a clearly erroneous interpretation of a provision of TRA 86 that does not even apply to Petitioner. (Pet. 17.)

Fourth, Petitioner argues that it should be permitted to avoid tax by (i) disavowing its entire role in the tax-shelter transaction for which it was created, inconsistently with its own reporting of the transaction (Pet. 21), and (ii) rejecting the findings of fact in the district court below.

When Petitioner's meritless arguments are stripped away, there is no issue in this case that warrants this Court's consideration.

B. There Is No Basis for This Court To Disturb the Determination of the Courts Below That Petitioner Did Not Meet Its Burden of Proving That It Was Not Negligent

Petitioner mischaracterizes the decisions below when it asserts that "to leave undisturbed the Third Circuit's summary affirmance would resurrect a strict liability theory of tax negligence . . . ." (Pet. 12.) In fact, there are substantial grounds in the record, having nothing to do with a "strict theory of tax negligence," for the Third Circuit's affirmance of the district court's judgment, and Petitioner's only cause for complaint is that the court of appeals did not explain its decision in an opinion, a complaint that does not merit this Court's consideration.

In the district court proceedings below, the VIBIR argued that the court should sustain the penalties asserted under I.R.C. § 6653(a) for either of two reasons: first, because Petitioner had intentionally disregarded Rev. Rul. 80-40, 1980-1 C.B. 175 (Resp. App.

4a-7a); second, because Petitioner could not reasonably rely on an opinion from Danielson, who was the promoter of the tax haven theory and could not render independent advice (Resp. App. 8a-9a). The VIBIR did not argue that Petitioner was negligent because Petitioner relied on negligent counsel—in fact, the VIBIR did not even assert that Danielson was negligent.

The district court sustained the penalty on grounds that are, frankly, unclear. (*See* Pet. App. 10a.) First, the district court correctly noted that "[t]he taxpayer has the burden of proving the absence of negligence . . ." and observed that "[Petitioner's] position is that it was not negligent because it relied on advice of its legal counsel in determining its tax liability." As the cases cited by Petitioner make clear, a taxpayer taking this position has the burden of proving that it *reasonably* relied on advice of counsel. *See, e.g., Hanson v. Commissioner*, 696 F.2d 1232, 1234 (9th Cir. 1983). The district court, however, made no finding of reasonable reliance. The court also stated: "[I]f its legal counsel were negligent, [Petitioner] would be liable under this section," but this was mere dictum since the court had made no finding that Petitioner reasonably relied on counsel in determining Petitioner's tax liability. The court then added: "There is no showing that [Petitioner's] counsel was other than negligent." Finally, the court stated that the record did not "support a finding of intentional disregard of the tax rules or regulations."

On appeal to the Third Circuit, the VIBIR did not argue that the district court's decision should be affirmed because Petitioner's counsel was negligent, nor did the VIBIR even assert that Danielson was neg-

ligent. Instead, the VIBIR asked the court of appeals to take plenary review of the district court's holding and determine that Petitioner intentionally disregarded rules and regulations. (Resp. App. 16a.) In this regard, the VIBIR argued that the district court had ignored *Business Ventures International v. Olive*, 893 F.2d 641 (3d Cir. 1990), in which the Third Circuit had previously determined that disregard of Rev. Rul. 80-40 is a sufficient basis for sustaining the penalty under I.R.C. § 6653(a). (Resp. App. 17a.) The VIBIR also repeated its position that it was not reasonable for Petitioner to rely on Danielson's opinions due to Danielson's status as the "promoter" of the tax haven theory. (Resp. App. 19a-21a.) On this record, the Third Circuit affirmed the *judgment* of the district court, without issuing its own opinion or adopting the opinion of the district court.

In sum, the basis for the district court's decision below is unclear, and there is no reason to assume that the court of appeals below affirmed the district court's decision on the basis of a "strict theory of tax negligence." At the same time, the VIBIR provided the court of appeals with two substantial grounds, having nothing to do with Danielson's possible negligence, for affirming the district court decision. Accordingly, the determination that Petitioner is liable for the penalty under I.R.C. § 6653(a) is not worthy of review by this Court.

C. Under the Plain Language of the Applicable Statutes and All of the Relevant Case Law, the Penalty for Substantial Underpayment of Income Taxes Provided in Section 6661 of the Internal Revenue Code May Be Imposed on a United States Person That Resides in the United States Virgin Islands

I.R.C. § 6661(a) provides:

> ADDITION TO TAX.—If there is a substantial understatement of income tax for any taxable year, there shall be added to the tax an amount equal to 25 percent of the amount of any underpayment attributable to such understatement.

Petitioner argues that the VIBIR has no authority to impose the penalty provided by I.R.C. § 6661(a). Petitioner argues that (i) I.R.C. § 6661 is part of Subtitle F of the Internal Revenue Code, (ii) Subtitle F of the Internal Revenue Code does not apply in the Virgin Islands, and (iii) the only procedural and administrative tax laws applicable to income taxation in the Virgin Islands are those rules found in Part II of Subtitle 1 of Title 33 of the Virgin Islands Code. (Pet. 14-15.) Petitioner's argument is devoid of merit and does not warrant this Court's attention.

The mirror system of taxation in the Virgin Islands became law in *1921*. Under the mirror system, "an individual or corporation in the Virgin Islands pays taxes to the [VIBIR] equivalent to the taxes an individual or corporation under the same circumstances in the United States would pay to the Internal Revenue Service," *Danbury*, 820 F.2d at 620. ROA § 28(a) became law in *1954*. Under ROA § 28(a), a Virgin Islands inhabitant must pay to the VIBIR "taxes owed under applicable provisions of the non-mirrored In-

ternal Revenue Code." *Danbury*, 820 F.2d at 623. Part II of Subtitle 1 of Title 33 of the Virgin Islands Code, 33 V.I.C. §§ 701 *et seq.*, on the other hand, was not enacted until *1957*.[15] Under Petitioner's position, therefore, there were absolutely no procedural and administrative laws applicable to Virgin Islands income taxation from 1921 to 1957![16]

Petitioner's only argument in support of this position is the unsupported assertion that the procedural and administrative rules in Subtitle F of the Internal Revenue Code are not "applicable taxing statutes" within the meaning of ROA § 28(a) (Pet. 13) or "income tax laws" within the meaning of the Naval Services Appropriation Act. (Pet. 14.) Petitioner cites absolutely no authority for these arguments. In fact,

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[15] Title 33 of the Virgin Islands Code was enacted by the Virgin Islands Legislature by Act No. 160, section 1, approved May 16, 1957.

[16] The procedural and administrative rules in Subtitle F of the Internal Revenue Code, which Petitioner asserts are not applicable in the Virgin Islands (except to the extent such rules are adopted by the Virgin Islands as local laws), include, among other things (i) all rules relating to the obligation to file income tax returns (Chapter 61),.(ii) all rules relating to the payment of income taxes (Chapter 62), (iii) all rules relating to assessment and collection of income taxes (Chapters 63 and 64), (iv) all rules relating to abatements, credits, and refunds of income taxes (Chapter 65), (v) all applicable statutes of limitations (Chapter 66), (vi) all rules relating to interest on underpayments and overpayments (Chapter 68), (vii) all rules relating to penalties (Chapter 68), (viii) all rules relating to closing agreements and compromises (Chapter 74), (ix) all rules relating to criminal income tax offenses (Chapter 75), (x) all rules relating to judicial proceedings in connection with income taxes, and (xi) all definitions of terms used in the Internal Revenue Code (Chapter 79).

no court has ever suggested that, prior to the enactment of Title 33 of the Virgin Islands Code, a taxpayer that would be subject to income tax penalties and interest under the I.R.C. could avoid payment of those penalties and interest simply because the taxpayer's income tax was owed to the Virgin Islands. Indeed, the "equality principle" articulated by the Third Circuit in *Chicago Bridge and Iron Co. v. Wheatley*, 430 F.2d 973, 975, n.2 (3d Cir. 1970), *cert. denied*, 401 U.S. 910 (1971), compels the conclusion that an inhabitant taxpayer must pay to the Virgin Islands the same penalties that it would pay to the United States if it were not an inhabitant.[17]

Moreover, the District Court of the Virgin Islands has held expressly that provisions in Subtitle F of the I.R.C. apply in the Virgin Islands. In *U.S. Virgin Islands v. Bank of America*, 17 V.I. 594, 595-96 (D.V.I. 1980), the district court held that I.R.C. § 7609 (which is contained in Subtitle F) applies in the Virgin

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[17] Ironically, Petitioner refers to footnote 2 of *Chicago Bridge and Iron Co.*, 430 F.2d 973, as support for Petitioner's position. That footnote observes, in dictum, that "Part II [of Title 33, Subtitle 1, of the Virgin Islands Code] comprises procedural and administrative provisions applicable to all Virgin Islands taxes, including the United States income tax." (Pet. 15.) The dictum is generally accurate, but, to the extent the rules in Title 33 of the Virgin Islands Code apply to the United States income tax, it is only because the same provisions are contained in the Internal Revenue Code, which applies in the Virgin Islands under the mirror system and the inhabitant rule. As the district court held in *U.S. Virgin Islands v. Bank of America*, 17 V.I. 594, 596 (D.V.I. 1980), the legislature of the Virgin Islands does not have the authority to determine which provisions of the I.R.C., "as it applies to income taxes," will be adopted in the Virgin Islands.

Islands even though it has not been enacted as part of Title 33 of the Virgin Islands Code. The court stated:

> Petitioners would read in an exception not apparent on the face of the Naval Appropriations Act, arguing that the provisions of Subtitle F of the Internal Revenue Code does (sic) not apply to the Virgin Islands. Further, argue petitioners, the Legislature of the Virgin Islands has not enacted § 7609 as a part of Title 33 of the Virgin Islands Code and that by reason of the failure of the Legislature of the Virgin Islands so to do, [the] would-be intervenors [in this case] can derive no benefit from the provisions of that section. This argument seems to the Court to be flawed in many respects . . . .

Finally, Petitioner is erroneous in asserting that "respondents' position leads to the absurd result that a Virgin Islands taxpayer is subject to Internal Revenue Code procedural and administrative provisions on United States source income and subject to the procedural and administrative provisions contained in Title 33, Part II (sic) of the Virgin Islands Code on its Virgin Islands source income." (Pet. 13) In fact, Respondents' position is that Subtitle F of the I.R.C. is applicable to all income taxes imposed in the Virgin Islands under the mirror code, and the rules in Title 33, Subtitle 1, Part II, Virgin Islands Code (other than those rules that accurately restate the rules in Subtitle F of the I.R.C.) are applicable only to Virgin Islands taxes other than income taxes.

D. Sections 1277(c)(2)(B)(ii) and 1277(c)(2)(E) of the Tax Reform Act of 1986 Do Not Prevent the Virgin Islands From Taxing Petitioner on Certain Income That Is Exempt From United States Tax Under Section 1277(c)(2)(E) of Such Act

When Congress repealed the "inhabitant rule" by enacting TRA 86 § 1275(b), Congress granted two targeted exceptions to the retroactive application of that provision. The exception set forth in TRA 86 § 1277(c)(2)(D) applies to a taxpayer called "Bizcap". *See Bizcap, Inc. v. Olive*, 892 F.2d at 1167. The exception set forth in TRA § 1277(c)(2)(E) applies to Petitioner. (Pet. App. 32a.) The two exceptions are identical except for the descriptions of the taxpayers and transactions to which they apply. Each exception states that, as to the taxpayer or transactions to which the exception applies, "In the case of any pre-1987 open year, the amendment made by section 1275(b) shall not apply . . . ."

In *Bizcap*, the Third Circuit Court of Appeals held that (i) the language quoted above simply treated Bizcap, for all pre-1987 open years, as though the inhabitant rule had not been repealed, and (ii) under the court of appeals' holding in *Danbury*, 820 F.2d 618, the inhabitant rule required Bizcap to pay tax to the Virgin Islands on Bizcap's income from all sources. The Supreme Court subsequently rejected Bizcap's petition for a writ of certiorari. 496 U.S. 905 (1990). In the decision below, the district court simply followed the holding in *Bizcap*, noting that "[Petitioner] now makes the same argument that Bizcap made and which the third circuit has already rejected." (Pet. App. 8a.) The decision below is correct, this Court has already rejected a petition for a writ

of certiorari in an identical case, and there is no basis for the Court to reach a different conclusion in this case.

In light of the decisions in *Bizcap*, Petitioner argues that (i) TRA 86 § 1277(c)(2)(B)(ii) (a provision not addressed in *Bizcap*) "deprived the Virgin Islands of the right to collect the tax revenue generated by the retroactive repeal [of the inhabitant rule] by providing that only taxes paid to the Virgin Islands on or before the date of enactment would be credited against the taxpayer's liability to the United States with respect to non-Virgin Islands source income" (Pet. 17), and (ii) the Third Circuit's decision in *Bizcap* was wrong because the court did not consider this point in deciding that case. (Pet. 19.)

Petitioner's argument is singularly unfounded. Not only does Petitioner mischaracterize the purpose and effect of TRA 86 § 1277(c)(2)(B)(ii), that provision does not even apply to Petitioner! Both of these points are quite simple. Since TRA 86 § 1275(b) repealed the inhabitant rule retroactively for all taxable years not barred by the statute of limitations, it followed that, the moment the statute was enacted, Virgin Islands inhabitants with United States source income in "open" years owed taxes to the United States on that income. Many of those taxpayers, however, had already paid taxes on that income to the Virgin Islands (individuals residing in the Virgin Islands, for example). TRA 86 § 1277(c)(2)(B)(ii) (which is reproduced at Pet. App. 48a-49a) simply allowed such taxpayers to credit the tax payments they had already made to the Virgin Islands against their newly created, retroactive tax liabilities to the United States. TRA 86 § 1277(c)(2)(B)(ii) does nothing more than pro-

vide a credit against tax owed to the United States and has nothing whatsoever to do with either the determination of any tax owed to the Virgin Islands or the VIBIR's power to collect such tax. Moreover, since TRA 86 § 1277(c)(2)(B)(ii) provides a credit only against taxes owed to the United States *by reason of the retroactive repeal of the inhabitant rule*, it cannot possibly apply to Petitioner, which is exempted from such United States taxes by TRA 86 § 1277(c)(2)(E).

E. There Is No Basis for This Court to Disturb the Determination of the District Below That a Certain Sale of Property Occurred After the Property Was Transferred to Petitioner and That Petitioner Was Therefore Taxable on the Gain From the Sale

Petitioner urges that it cannot be liable for tax on gain from a sale of certain California real estate because (i) Petitioner was inserted into the sale transaction "only to take advantage of the perceived benefit that would be available to it" under the tax haven theory, and (ii) Petitioner did not participate in a meaningful way in the sales negotiations. (Pet. 21.) Petitioner theorizes that, under these facts, the courts below erred when they failed to hold that the "step transaction" and "assignment of income" doctrines protected Petitioner from tax. (Pet. 19-22.) In pursuit of this theory, Petitioner proposes to disavow its entire role in the transactions for which it was created as well as its consistent reporting of those transactions on its tax returns. (Pet. 21.)

Petitioner's arguments are utterly without merit.

Petitioner was created by Lansdale as part of a tax-avoidance scheme, and all of the transactions involved in this case were carefully designed so that the income generated by the transactions would be

Petitioner's income and not Lansdale's. Consistently with the tax avoidance purpose and actual form of the transaction, Petitioner reported the income from the transactions, while Lansdale did not. (Pet. 4-6, Pet. 21; Pet. App. 28a-29a; Pet. App. 35a.) Petitioner even prevailed upon the Congress of the United States to grant Petitioner an exemption from U.S. taxation of the income from those transactions (Pet. App. 32a.), an exemption that would have been meaningless if the income were not Petitioner's. All of this was done solely because Lansdale hoped to pay no tax on millions of dollars of income. Now, when Petitioner's meticulously constructed tax shelter has failed, Petitioner seeks to persuade this Court that the courts below violated "long settled principles of income tax law" (Pet. 19.) by holding Petitioner to the consistently reported form of its transaction. There is no precedent that permits a taxpayer to avoid tax by disavowing the chosen form of a tax avoidance transaction, and Petitioner's argument is not worthy of consideration by this Court.[18]

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[18] Petitioner argues that, in this case, the taxpayer should be permitted to disavow the form of its transaction because the VIBIR has "opened the recharacterization door" by treating the integrated creation/redemption of Petitioner's interest in the partnership acquiring the real estate as a "disguised sale." (Pet. 22-23.) In support of this proposition, however, Petitioner cites only a law journal article. *See* Smith, "Substance and Form: A Taxpayer's Right to Assert the Priority of Substance," 44 *Tax Lawyer* 137, 172-73 (Fall 1990). Moreover, Petitioner fails to refer to the following crucial passage from the discussion in that article:

> [A] taxpayer should not be permitted to use the [Internal Revenue] Service's application of the substance over form principle as an excuse to

Moreover, even if Petitioner were not bound by the form of its transaction, the decisions below would still be correct, because the substance-over-form doctrines Petitioner cites do not apply to this case.

First, although Petitioner argues that the district court failed to undertake "a proper step transaction analysis" (Pet. 20), the step transaction doctrine is simply irrelevant to the question of whether Petitioner is taxable. It is of course true that the transfer of property by Petitioner to a newly formed partnership in exchange for a 24-percent partnership interest, coupled with the simultaneous redemption of 23/24 of that partnership interest for cash and notes (*see* Pet. 21), constituted "interrelated yet formally distinct steps in an integrated transaction [that] may not be considered independently of the overall transaction." *See Commissioner v. Clark*, 489 U.S. 726, 738 (1989), quoted at Pet. 20. Thus, the step transaction doctrine was properly applied to disregard the transitory acquisition and redemption of the partnership interest. On the other hand, Petitioner's prior acquisition of the transferred property was anything but transitory. In that prior transaction, Petitioner acquired valuable

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> impeach form in ways not reasonably related to the Service's position .... The test ... should seek to distinguish between a defensive taxpayer position and a taxpayer position which uses the Service's claim merely as an excuse for impermissible post-transactional tax planning.

Id., at 173. In this case, the only function of Respondent's "recharacterization" of Petitioner's partnership transaction is to treat Petitioner's income as ordinary income rather than capital gain. Thus, Petitioner's post-transactional attempt to escape taxation completely by disavowing its entire role in the transaction would be rejected by the very commentator cited by Petitioner.

property from Lansdale as a capital contribution (Pet. App. 25a), and, after Petitioner exchanged that property for cash and notes in the integrated partnership transaction described above, Petitioner retained ownership of the cash and notes.

Second, there is no basis for Petitioner's argument that, "under the assignment of income doctrine and long established precedents of this Court, petitioner is not properly liable for tax with respect to [the income from the California real estate transactions]," citing *Commissioner v. Court Holding Co.*, 324 U.S. 331 (1945), and *Waltham Netoco Theatres, Inc. v. Commissioner*, 401 F.2d 333 (1st Cir. 1968).[19] (Pet. 21.) Those cases, which require a corporation to pay tax on gain from a sale of property *by the corporation* even though, in form, the property is conveyed by the corporation to its shareholders who then convey the property to the purchaser in exchange for the purchase price, do not apply to Petitioner. In *U.S. v. Cumberland Public Service Co.*, 338 U.S. 451 (1950), this Court held that *Court Holding Co.* does not control where, as a matter of fact, the sale is made by the shareholders rather than the corporation. Since the district court below determined as a factual matter that "Lansdale transferred all his interest in the property to [Petitioner] on March 11, 1981 prior to sale of that property the next day . . ." (Pet. App. 9a), there is no basis for applying *Court Holding Co.* In essence, Petitioner simply disagrees with the district court's factual determination.

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[19] Petitioner also cites *Hines v. U.S.*, 477 F.2d 1063 (5th Cir. 1973). In *Hines*, however, the court determined that the assignment of income doctrine did not apply.

In sum, the courts below correctly determined that Petitioner is taxable on the gain it reported, and there is no reason for this Court to review their decision.

CONCLUSION

The decision below is correct, does not conflict with any precedent of this Court or, indeed, of any other court, and does not raise any issue of sufficient importance to warrant this Court's attention. Thus, no basis exists for granting the Petition for a Writ of Certiorari to the United States Court of Appeals for the Third Circuit. Respondent respectfully requests that the Petition be denied.

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APPENDIX

APPENDIX

IN THE DISTRICT COURT OF THE VIRGIN ISLANDS

DIVISION OF ST. THOMAS & ST. JOHN

CIVIL NOS. 86-263,
88-12 and 88-270

LA ISLA VIRGEN, INC.

Petitioner,

vs.

ANTHONY P. OLIVE, DIRECTOR VIRGIN ISLANDS BUREAU OF INTERNAL REVENUE

Respondent.

PETITIONS FOR REDETERMINATION OF INCOME TAX LIABILITY

MEMORANDUM IN SUPPORT OF VIBIR OPPOSITION TO PETITIONER'S MOTION FOR SUMMARY JUDGMENT AND RESPONDENT'S CROSS MOTION FOR SUMMARY JUDGMENT

COMES NOW, the Virgin Islands Bureau of Internal Revenue (VIBIR), by and through undersigned counsel, and respectfully requests that this Court deny the Petitioner's Motion for Summary Judgment and grant Respondent's Cross Motion for Summary Judgment. In support of its Opposition to petitioner's Motion and in further support of Respondent's Cross Motion for Summary Judgment the VIBIR submits the following memorandum.

I. SUMMARY OF ARGUMENT

It is the position of the Virgin Islands Bureau of Internal Revenue ("VIBIR") that the plain language of TRA 86 Section 1277(c)(2)(E) provides that LIV owes tax on its income from all sources to the VIBIR for the years at issue in this case. Section 1277(c)(2)(E), read together with the operative term "pre-1987 open year", defend at Section 1277(c)(2)(C) and construed by the Court of Appeals in *Danbury Inc. v. Olive*, 627 F. Supp. 513 (D.V.I. 1986), *rev'd* 820 F.2d 618 (3d Cir. 1987). *cert. denied* 484 U.S. 964 (1987), is contrary to LIV's claim of tax exemption. It is the position of the VIBIR that the statute is unambiguous. The result of LIV's exception from **retroactive** repeal is to hold LIV liable to the VIBIR for the pre-1987 tax years for which the VIBIR filed a deficiency notice within the statute of limitations, just as the Court of Appeals for the Third Circuit held in *Bizcap, Inc. v. Olive*, 892 F.2d 1163, 1164 (3d Cir. 1989) *cert. denied* ___ U.S. ___ (June 4, 1990). It is now beyond dispute that Section 28(a), the so called "inhabitant rule", never created any tax loophole and, that the targeted exceptions to **retroactive** repeal of the "inhabitant rule" did not give rise to a "tax haven" that never existed under a proper interpretation of prior law.

The timely statutory notices of deficiency issued by the VIBIR to LIV are attached as Petitioner's Exhibits 1, 2 and 3. As more fully set forth below, the VIBIR maintains that, with the exception of the installment sale and capital gain issues relative to the 1983 sale of the oil and gas property conceded below, the notices accurately calculate the income tax liability on worldwide income of LIV for the years at issue and properly assert the penalties owed under applicable statutes.

The VIBIR concedes that LIV may use the installment sale method in reporting the gain from the 1983 sale of LIV's oil and gas property based on the Third Circuit's

1990 decision in *Business Ventures International, Inc. v. Olive*, 893 F.2d 641 (3d Cir. 1990). In addition, the VIBIR concedes that LIV is entitled to calculate the income tax on this gain using rates applicable to capital gains.

The VIBIR requests that this Court affirm the VIBIR determination in all other respects.

* * *

IV. THE ASSESSMENT OF PENALTIES FOR FAILURE TO PAY TAX UNDER I.R.C. SECTION 6653(a) IS PROPER AND SHOULD BE SUSTAINED.

I.R.C. Section 6653(a)(1) imposes a penalty of 5 percent of any underpayment, as defined in subsection (c), of certain taxes, including income taxes, and which underpayment "is due to negligence or intentional disregard of rules and regulations (but without intent to defraud)." Subsection (a)(2), applicable to returns the due dates of which are prior to January 1, 1987, imposes an additional penalty equal to 50 percent of the interest on the underpayment described in subsection (a)(1) and running from the date the tax payment was due to the earlier of the date of assessment or payment of the tax.

The VIBIR assessed the penalty under I.R.C. section 6653(a)(1) and (2) for the fiscal years ended February 28, 1982, 1983, 1984, 1985, and 1986. (See Exhibits 1, 2, and 3.). The penalty was asserted due to LIV's failure to include non-Virgin Islands source income in taxable income as required by the Revised Organic Act of the V.I. of 1954. The addition to tax is presumptively correct and must stand unless the taxpayer can establish that the assessment of the penalty was erroneous. *Hall v. Commissioner*, 729 F.2d 632 (9th Cir. 1984). *Business Ventures International v. Olive*, 893 F.2d 641 (3d Cir. 1990). When a penalty is asserted under section 6653(a) the taxpayer has the burden to prove (1) that he was not negligent **and** (2) that he did not intentionally disregard rules or regu-

lations. *Business Ventures International* at 646; *Marcello v. Comm.*, 380 F.2d 499, 506 (5th Cir. 1967).

In reviewing the application of the 6653(a) penalty to the precise tax shelter scheme employed by LIV, the Court of Appeals for the Third Circuit has squarely held that disregard of Revenue Ruling 80-40 constitutes intentional disregard of a rule. *Business Ventures International* at 646.

LIV knowingly and intentionally disregarded rules and regulations when it filed its returns claiming that it was not required to pay tax on its income from sources outside the Virgin Islands. At the time LIV's returns were filed, Revenue Ruling 80-40 plainly precluded the taxpayer's treatment of its non-Virgin Islands source income. *Business Ventures International* at 646. See also *Island Acres, Inc. v. Olive*, 893 F.2d 647 (3d Cir. 1990) and *Affiliated Development Corp. v. Olive*, 893 F.2d 647 (3d Cir. 1990). LIV's advisor, Mr. Gustav A. Danielson repeatedly alerted the parties to the IRS Revenue Ruling 80-40, which was contrary to the reporting position that LIV was taking, in his opinion letter dated September 25, 1981. See Stipulation #67 and Exhibit 66 at pages 1, 13, 14 and 15. In the first paragraph of the September 25, 1981, opinion letter, Mr. Danielson plainly states that his legal opinion conflicts with revenue rulings and "in rare instances" regulations. Mr. Danielson stresses, "It is, therefore important that you recognize the Internal Revenue Service has taken a position contrary to our own and announced, formally, the policy which they intend to follow." See page 1 of Exhibit 66.

As noted by the Court in *Danbury*, the Internal Revenue Service had explained its reading of Section 28(a) of the Revised Organic Act in Revenue Ruling 80-40, 1980-1 C.B. 175. *Danbury* at 624. The issuance of rules and regulations is authorized by I.R.C. section 7805(a). Section 7805(b), "retroactivity of Regulations or Rulings," demonstrates

that the terms "rule" and "ruling" are used interchangeably in the statute. See *Business Ventures International* at 646.

Rev. Rul. 80-40 concluded that a V.I. inhabitant U.S. chartered corporation satisfied both its United States and Virgin Islands income tax obligations by paying the Virgin Islands income tax on its income from all sources. As Mr. Danielson advised LIV at page 6 of his opinion letter dated September 25, 1981, (Exhibit 66), this ruling was also the authority for the proposition that such a corporation could be an "inhabitant". See also page 7 of Exhibit 67. Pages 14 and 15 of the opinion at Exhibit 66 plainly prove LIV was advised of both the existence and holding of Rev. Rul. 80-40. The corporation chose to disregard this ruling and assume the risks of its tax avoidance scheme.

LIV has not alleged and can not produce any evidence that it did not intentionally disregard revenue ruling 80-40. Rather, LIV ignores the 1990 Third Circuit Court of Appeals decision in *Business Ventures International* which is on point and contrary to LIV's argument at pages 55 through 61 of its memorandum. Further, LIV flatly misstates the law as it relates to disclosure and intentional disregard of rules and regulations.

LIV baldly asserts at page 55 of its Memorandum that, "LIV's full disclosure should also preclude imposition of penalties for disregard of rules and regulations." This quite simply is not the law. The cases cited by LIV are inapposite.

The "intentional disregard" penalty of I.R.C. Section 6653(a) was designed to deter taxpayers from abusing prepayment deficiency procedures by intentionally underpaying and then contesting the deficiency. *Druker v. Comm.*, 697 F.2d 46, 54 (2d Cir. 1982), *cert. denied*, 103 S.Ct. 2429 (1983). If a taxpayer wishes to contest a "rule or regulation" without risk of penalty, his recourse is to pay the tax and then sue for refund. *Id.*

While the line between intentional disregard of rules or regulations on the one hand and fraud on the other hand may be fine, the line is nevertheless clear. That is, an intentional disregard of rules or regulations that is fully disclosed on the taxpayer's return and is not accompanied by affirmative acts of concealment, deceit, or misrepresentation is not fraudulent. See, *e.g.*, *Druker* at 53.

Beyond the issue of fraud, disclosure of the improper reporting position is irrelevant to the imposition of the penalty. In its thorough analysis of the intentional disregard standards under I.R.C. Sections 6653(a) and 6694(a), the Second Circuit noted in *Druker* that Congress had considered an alternative standard to the mandatory imposition of the addition under I.R.C. Section 6653(a) for intentional disregard. In 1954, the Senate Finance Committee proposed an amendment to I.R.C. Section 6653(a) that would have permitted a taxpayer who consciously disregards a rule or regulation to avoid the addition by attaching a statement to his return explaining the rules or regulations disregarded and the grounds on which he believes them invalid. S. Rep. No. 1622, 83rd Cong., 2d Sess. 591 (1954). This amendment was deleted in conference leaving in force the cases refusing to allow any reasonable cause defense where the addition was based on an intentional disregard of rules and regulations. See *Druker* at 54. The Court went on to distinguish I.R.C. Section 6694(a), which provides a "reasonable basis exemption" for good faith intentional disregard of a rule or regulation by a tax return *preparer*, and I.R.C. Section 6653(a) which provides no such exemption for a *taxpayer*. In holding the addition for intentional disregard under I.R.C. Section 6653(a) mandatory, the Court noted that the construction of this section has been settled since 1942. *Id.* at 55.

Clearly, *Druker v. Comm.*, 697 F.2d 46, 53-54 (2d. Cir. 1982), *cert. denied*, 103 S.Ct. 2429 (1983), is contrary to LIV's assertion that disclosure negates the penalty under I.R.C. Section 6653(a) (Reasonableness of taxpayers action

may be relevant when he is charged with negligence, but not when he has admittedly flouted applicable rules and regulations which he fully understood). Disclosure distinguishes intentional disregard of rules and regulations under I.R.C. Section 6653(a) from civil fraud under I.R.C. Section 6653(b). See *Raley v. C.I.R.*, 676 F.2d 980, 983 n. 7 (3d Cir. 1982). Citing *Druker* and *Raley* the Tenth Circuit has also recognized this distinction stating;

> Thus, under traditional definitions of fraud, disclosed defiance of the tax laws is not fraudulent. Rather it is intentional disregard of the rules and regulations—an offense for which Congress has expressly provided a penalty under section 6653(a). . . . The interrelation of sections 6653(a) and (b) makes it clear that the civil fraud provision does not reach mere intentional disregard of rules and regulations. *Zell v. Comm.*, 763 F.2d 1139, 1144 (10th Cir. 1985).

The BIR respectfully submits that LIV's alleged "disclosure" is irrelevant to imposition of the penalty under Section 6653(a). As more fully set forth in the discussion of disclosure under the Section 6661 penalty below, it is the VIBIR's position that the tax returns filed by LIV did not disclose LIV's participation in the "28(a) tax shelter" scheme. LIV's view of the law with regard to intentional disregard of rules and regulations is contrary to the interpretations of at least three Circuit Courts of Appeal. LIV's authority for its proposition are outdated, distinguishable and do not support the proposition urged upon this Court.

LIV could only avoid the section 6653(a) penalty if it established that it did not intentionally disregard Revenue Ruling 80-40. *Business Ventures International* at 646. The record is clear that LIV consciously chose to disregard the ruling. The law of this Circuit under these facts and circumstances is clear and unassailable. The penalty applies as a matter of law. *Id.*

LIV is also required to prove that it was not negligent in its claimed reporting position. Negligence is determined by the reasonable, prudent person standard. *Zmulda v. Comm.*, 731 F.2d 1417 (9th Cir. 1984). LIV has claimed reliance on counsel as its defense to the assertion of negligence. To overcome a negligence penalty the taxpayer must prove not only that he relied on competent counsel, but also, that such reliance was reasonable and in good faith. *Ward v. Comm.*, 47 T.C.M. (CCH) 588 (1983), *Preston v. Comm.*, 47 T.C.M. (CCH) 417 (1983).

LIV has not produced evidence that it reasonably relied on competent counsel. The evidence offered by the Petitioner in this case to disprove negligence are the opinions of Gustav Danielson. Established case law places a greater burden on the taxpayer to establish **reasonable** reliance.

In this regard, it has been held than an investor was liable for negligence penalties because he could not have reasonably relied upon the advice of promoters or persons who the promoters introduced to the taxpayer as "tax professionals" because those persons were not independent of the promoters. His reliance on their advice was not reasonable because of his failure to obtain independent advice from tax professionals not connected with the shelter. *Bilyeu v. Comm.*, 55 T.C.M. (CCH) 836 (1988). Here, LIV sought the opinion of the author of the "28(a) tax haven theory" whose advice and predisposition were known from the "portfolio." (See paragraphs 3. and 5. of the Affidavit of Stephen L. Newman at Exhibit 64.) Mr. Danielson was retained to incorporate LIV and became its first president. Rex Danielson, his son, served as Secretary, Treasurer and Director of LIV from March 1981 through all years at issue in this proceeding. (See Stipulation #7.) The VIBIR submits that Mr. Gustav A. Danielson was not independent of the promoter—he was the promoter.

The penalty has been sustained in the face of similar facts where the petitioner testified that he sought advice from an attorney or an accountant, but there was no evidence that either an attorney or an accountant advised the petitioner that the scheme would produce the desired tax advantages. *Brown v. Comm.*, 43 T.C.M. (CCH) 1322, 1324 (1982). In *Brown*, which involved a "family trust", considering that both petitioners were well educated, the Court found it difficult to believe that they could have envisioned the Trust as anything other than a flagrant tax avoidance scheme. Id.

The opinions proffered by LIV contain numerous caveats and potential problems associated with the " 28(a) tax haven theory." See Exhibits 66, pages 13 through 18, and 67 pages 3 and 9. To the extent that one could draw a reasonable conclusion from these documents, it was that the entire scheme was subject to attack on numerous grounds, would certainly be challenged by the taxing authorities and was unlikely to survive judicial review. Indeed, Mr. Danielson's letter to Governor King in 1975, at Exhibit 68, and his previously published work, at Exhibit 69, reach the same conclusion as that asserted by the VIBIR in its deficiency notices—the position upheld by the Court of Appeals in *Danbury*.

LIV has failed to meet its burden of proof to disprove both intentional disregard of Rev. Rul. 80-40 and negligence. On the record in this case, the penalty applies as a matter of law.

UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

No. 91-3202

LA ISLA VIRGEN, INC.,
Petitioner - Appellant

vs.

ANTHONY P. OLIVE, Director of Virgin Islands Bureau of Internal Revenue, and GOVERNMENT OF THE VIRGIN ISLANDS,
Respondents - Appellees

ON APPEAL FROM THE DISTRICT COURT OF THE VIRGIN ISLANDS DIVISION OF ST. THOMAS AND ST. JOHN
(D.C. Nos 86-263, 88-12, and 88-270)

BRIEF ON BEHALF OF ANTHONY P. OLIVE, ETC., RESPONDENTS - APPELLEES

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I. SUBJECT MATTER AND APPELLATE JURISDICTION

This appeal results from the determination of the District Court of the Virgin Islands that the income tax deficiencies assessed by Respondent-Appellee Anthony P. Olive, then Director of the Virgin Islands Bureau of Internal Revenue, Government of the Virgin Islands (hereinafter referred to as "VIBIR") against Petitioner-Apellant La Isla Virgen, Inc. (hereinafter referred to as "LIV") were correct.

The matter was properly before the District Court of the Virgin Islands, Division of St. Thomas and St. John, pursuant to section 994, Title 33, Virgin Islands Code, and Section 1612(a), Title 48, U.S.C. This court has Appellate jurisdiction pursuant to section 1613(c), Title 48, U.S.C. The appeal is from a final judgment in accordance with section 1291, Title 28, U.S.C.

II. ISSUES PRESENTED FOR REVIEW

Petitioner-Appellant has raised the following issues for review:

1. Whether the District Court erred in determining that Section 1277(c)(2)(E) of the Tax Reform Act of 1986 (hereinafter referred to as "TRA 86") does not bar the VIBIR from assessing income tax liability against LIV with respect to income attributable to transactions specified in that statute.

2. Whether the District Court erred in determining that the redemption and disposition of certain limited partnership interests in 1981 and 1983 are properly characterized as a sale by LIV.

3. Whether the District Court erred in adopting the VIBIR's recharacterization of the transactions without applying a step transaction analysis to support its determination that the redemption and dispositions of limited partnership interests constituted a taxable sale by LIV.

4. Whether the District Court erred in finding that gain attributable to the redemption and disposition of limited partnership interests does not qualify for the alternative tax rate on capital gains.

5. Whether the District Court erred in determining that LIV is liable for penalties under sections 6651, 6653, and 6661 of the Internal Revenue Code (hereinafter the "IRC").

III. STATEMENT OF THE CASE

The case involves the District Court's grant of the VIBIR's Cross-Motion for Summary Judgment and resulting determination of deficiencies in taxes as to LIV for the years 1981, 1982, 1983, 1984, and 1985 and deficiencies for penalties under IRC sections 6651, 6653, and 6661 (and denial of LIV's Motion for Summary Judgment). LIV filed its Notice of Appeal on March 27, 1991, and this proceeding follows.

IV. STATEMENT OF FACTS

The VIBIR and LIV filed a 29-Page Stipulation of Facts (hereinafter the "Stipulation"), Appendix pp. 315A-343A,

with the District Court on October 29, 1990, which sets out the facts upon which the VIBIR's Cross-Motion for Summary Judgment and this brief are based.

V. STATEMENT OF RELATED CASES

No other cases are presently on appeal to this Court or docketed in the District Court of the Virgin Islands involving the issue of the authority of the Virgin Islands to tax a U.S. corporation which is an "inhabitant" of the Virgin Islands pursuant to 48 U.S.C. section 1642, where the corporation has been granted a targeted exception by the Tax Reform Act of 1986. This case also involves the application of certain principles of Federal income tax law to certain transactions. The VIBIR does not know whether any other cases involving these issues are presently on appeal to this Court or docketed in the District Court of the Virgin Islands.

VI. STANDARD FOR REVIEW

LIV contends that the District Court erred in formulating or applying the law, and that review by this Court of the questions of interpretation and application of the law is plenary. (Citing cases including *Minizza v. Stone Container Corp.*, 842 F.2d 1456, 1459 (3d Cir. 1988). The VIBIR disagrees with this contention of error and agrees with the formulation and application of the law by the District Court, except in the District Court's failure to find that LIV intentionally disregarded income tax rules as one basis for imposing penalties under IRC section 6653(a). However, the VIBIR agrees with the LIV assertion of the standard for review herein.

VII. SUMMARY OF ARGUMENT

It is the VIBIR's position that the plain language of TRA 86 Section 1277(c)(2)(E) provides that LIV owes tax on its income from all sources to the VIBIR for the years

at issue in this case. TRA 86 Section 1277(c)(2)(E), read together with the operative term "pre-1987 open year," defined at Section 1277(c)(2)(C), and construed by the Third Circuit Court of Appeals in *Danbury Inc. v. Olive*, 627 F. Supp. 513 (D.V.I. 1986), *rev'd* 820 F.2d 618 (3d Cir. 1987). *cert. denied* 484 U.S. 964 (1987), is contrary to LIV's claim of tax exemption. The statute is unambiguous. The result of LIV's exception from retroactive repeal is to hold LIV liable to the VIBIR for the pre-1987 tax years for which the VIBIR filed a deficiency notice within the statute of limitations, just as the Court of Appeals for the Third Circuit held in *Bizcap, Inc. v. Olive*, 892 F. 2d 1163, 1164 (3d Cir. 1989) *cert. denied* ___ U.S. ___ (June 4, 1990). It is now beyond dispute that Section 28(a), the so-called "inhabitant rule", never created any tax loophole and that the targeted exceptions to retroactive repeal of the "inhabitant rule" did not give rise to a "tax haven" that never existed under a proper interpretation of prior law.

The VIBIR issued timely statutory notices of deficiency. As more fully set forth below, the VIBIR maintains that with the exception of the installment sale and capital gain issues relative to the 1983 sale of the oil and gas property conceded in its Cross-Motion for Summary Judgment in the District Court, the notices accurately calculate the income tax liability on worldwide income of LIV for the years at issue and properly assert the penalties owed under applicable statutes.

The VIBIR requests this Court affirm the determination of the District Court in all respects, and that the Court also determine that the VIBIR can assess the penalty under

IRC section 6653(a) based on LIV's intentional disregard of the applicable income tax rules and regulations.

* * *

X. THE ASSESSMENT OF PENALTIES FOR FAILURE TO PAY TAX UNDER IRC SECTION 6653 (a) WAS PROPERLY SUSTAINED BY THE DISTRICT COURT, BUT THE VIBIR REQUESTS THE COURT OF APPEALS TO ALSO FIND INTENTIONAL DISREGARD.

IRC Section 6653(a)(1) imposes a penalty of five percent of any underpayment, as defined in subsection (c), of certain taxes, including income taxes, and which underpayment "is due to negligence or intentional disregard of rules and regulations (but without intent to defraud)." Subsection (a)(2), applicable to returns with due dates prior to January 1, 1987, imposes an additional penalty equal to 50 percent of the interest on the underpayment described in subsection (a)(1) running from the date the tax payment was due to the earlier of the date of assessment or payment of the tax.

The VIBIR assessed the penalty under I.R.C. section 6653(a)(1) and (2) for the fiscal years ended February 28, 1982, 1983, 1984, 1985, and 1986. The penalty was asserted due to LIV's failure to include non-Virgin Islands source income in taxable income as required by the Revised Organic Act of the V.I. of 1954. The addition to tax is presumptively correct and must stand unless the taxpayer can establish that the assessment of the penalty was erroneous. *Hall v. Commissioner*, 729 F.2d 632 (9th Cir. 1984); *Business Ventures International v. Olive*, 893 F.2d 641 (3d Cir. 1990). When a penalty is asserted under section 6653(a) the taxpayer has the burden to prove (1) that he was not negligent and (2) that he did not intentionally disregard rules and regulations. *Business Ventures International* at 646; *Marcello v. Comm.*, 380 F.2d 499, 506 (5th Cir. 1967).

The District Court held that the record does not support a finding of intentional disregard of rules and regulations. The VIBIR disagrees with this finding and respectfully requests this Court to take plenary review of the District Court's holding in this matter and to determine that the taxpayer demonstrated an intentional disregard of rules and regulations in the present case as well as negligence. There is ample authority to support such a finding by this court. Specifically, in reviewing the application of the IRC 6653(a) penalty to the precise tax shelter scheme employed by LIV, this Court has squarely held that disregard of Revenue Ruling 80-40 constitutes intentional disregard of a rule. *Business Ventures International* at 646.

LIV knowingly and intentionally disregarded rules and regulations when it filed its returns claiming that it was not required to pay tax on its income from sources outside the Virgin Islands. At the time LIV's returns were filed, Revenue Ruling 80-40 clearly and unambiguously precluded the taxpayer's treatment of its non-Virgin Islands source income. *Business Ventures International* at 646. *See also Island Acres, Inc. v. Olive*, 893 F.2d 647 (3rd Cir. 1990) and *Affiliated Development Corp. v. Olive*, 893 F.2d 647 (3d Cir. 1990). LIV's advisor, Mr. Gustave A. Danielson, repeatedly alerted the parties to the IRS Revenue Ruling 80-40, which was contrary to the reporting position that LIV was taking, in his opinion letter dated September 25, 1981. *See* Stipulation #67, Appendix p. 341A. In the first paragraph of the September 25, 1981, opinion letter, Mr. Danielson plainly states that his legal opinion conflicts with revenue rulings and "in rare instances" regulations. Appendix p. 867A. Mr. Danielson stresses, "It is, therefore, important that you recognize the Internal Revenue Service has taken a position contrary to our own and announced, formally, the policy which they intend to follow." As noted by the court in *Danbury*, the Internal Revenue Service had explained its reading of Section 28(a) of the ROA in Revenue Ruling 80-40, 1980-1 C.B. 175. *Danbury* at 624.

The issuance of rules and regulations is authorized by I.R.C. section 7805(a). I.R.C. Section 7805(b), Retroactivity of Regulations or Rulings, demonstrates that the terms "rule" and "ruling" are used interchangeably in the statute. *See Business Ventures International* at 646.

Rev. Rul. 80-40 concluded that a V.I. inhabitant U.S. chartered corporation satisfied both its United States and Virgin Islands income tax obligations by paying the Virgin Islands income tax on its income from all sources. As Mr. Danielson advised LIV at page 6 of his opinion letter dated September 25, 1981, this ruling was also the authority for the proposition that such a corporation could be an "inhabitant." Pages 14 and 15 of the opinion plainly prove LIV was advised of both the existence and holding of Rev. Rul. 80-40. Appendix pp. 880A-881A. The corporation chose to disregard this ruling and assume the risks of its tax avoidance scheme.

LIV has not alleged and can not produce any evidence that it did not intentionally disregard Revenue Ruling 80-40. Rather, LIV and the District Court below ignore the 1990 Third Circuit Court of Appeals decision in *Business Ventures International.*

The "intentional disregard" penalty of I.R.C. Section 6653(a) was designed to deter taxpayers from abusing prepayment deficiency procedures by intentionally underpaying and then contesting the deficiency. *Druker v. Comm.*, 697 F.2d 46, 54 (2nd Cir. 1982), *cert. denied*, 103 S.CT. 2429 (1983). If a taxpayer wishes to contest a "rule or regulation" without risk of penalty, his recourse is to pay the tax and then sue for refund. *Id.*

While the line between intentional disregard of rules or regulations on the one hand and fraud on the other hand may be fine, the line is nevertheless clear. That is, an intentional disregard of rules or regulations that is fully disclosed on the taxpayer's return and is not accompanied

by affirmative acts of concealment, deceit, or misrepresentation is not fraudulent. *See e.g., Druker* at 53.

Beyond the issue of fraud, disclosure of the improper reporting position is irrelevant to the imposition of the penalty. In its thorough analysis of the intentional disregard standards under I.R.C. Sections 6653(a) and 6694(a), the Second Circuit noted in *Druker* that Congress had considered an alternative standard to the mandatory imposition of the addition under I.R.C. Section 6653(a) for intentional disregard. In 1954, the Senate Finance Committee proposed an amendment to I.R.C. Section 6653(a) that would have permitted a taxpayer who consciously disregards a rule or regulation to avoid the addition by attaching a statement to this return explaining the rules or regulations disregarded and the grounds on which he believes them invalid. S. Rep. No. 1622, 83rd Cong., 2d Sess. 591 (1954). This amendment was deleted in conference leaving in force the cases refusing to allow any reasonable cause defense where the addition was based on an intentional disregard of rules and regulations. *See Druker* at 54. The Court went on to distinguish I.R.C. Section 6694(a), which provides a "reasonable basis exemption" for good faith intentional disregard of a rule or regulation by a tax return *preparer*, and I.R.C. Section 6653(a) which provides no such exemption for a taxpayer. In holding the addition for intentional disregard under I.R.C. Section 6653(a) mandatory, the Court noted that the construction of this section has been settled since 1942. *Id.* at 55.

Clearly, *Druker v. Comm.*, 697 F.2d 46, 53-54 (2d. Cir. 1982), *cert. denied*, 103 S.Ct. 2429 (1983), is contrary to LIV's assertion that disclosure negates the penalty under I.R.C. Section 6653(a). Disclosure distinguishes intentional disregard of rules and regulations under I.R.C. Section 6653(a) from civil fraud under I.R.C. Section 6653(b). *See Raley v. C.I.R.*, 676 F.2d 980, 983 n.7 (3rd Cir. 1982). *Citing Druker* and *Raley*, the Tenth Circuit has also recognized this distinction stating:

> Thus, under traditional definitions of fraud, disclosed defiance of the tax laws is not fraudulent. Rather it is intentional disregard of the rules and regulations—an offense for which Congress has expressly provided a penalty under section 6653(a) . . .

The interrelation of IRC sections 6653(a) and (b) makes it clear that the civil fraud provision does not reach mere intentional disregard of rules and regulations. *Zell v. Comm.*, 763 F.2d 1139, 1144 (10th Cir. 1985).

The BIR respectfully submits that LIV's alleged "disclosure" is irrelevant to imposition of the penalty under IRC Section 6653(a). As more fully set forth in the discussion of disclosure under the IRC Section 6661 penalty below, it is the VIBIR's position that the tax returns filed by LIV did not disclose LIV's participation in the "28(a) tax shelter" scheme. LIV's view of the law with regard to intentional disregard of rules and regulations is contrary to the interpretations of at least three Circuit Courts of Appeal. LIV's authority for its proposition are outdated, distinguishable, and simply do not support the proposition urged upon this Court.

LIV could only avoid the section 6653(a) penalty if it is established that it did not intentionally disregard Revenue Ruling 80-40 and was not negligent in its reporting position. *Business Ventures International* at 646. The record is clear that LIV consciously chose to disregard the ruling. The law of this Circuit under these facts and circumstances is clear and unassailable. The penalty applies as a matter of law. *Id.* Moreover, since LIV is also required to prove it was not negligent in its reporting position under the reasonable, prudent person standard (*Zmulda v. Comm.*, 731 F.2d 1417 (9th Cir. 1984)), it must prove not only reliance on competent counsel, but also that such reliance was reasonable and in good faith. *Ward v. Comm.*, 47 T.C.M. (CCH) 588 (1983), *Preston v. Comm.*, 47 T.C.M. (CCH) 417 (1983).

LIV has not produced evidence that it reasonably relied on competent counsel. The evidence offered by the Petitioner-Appellant in this case to disprove negligence are the opinions of Gustave Danielson. Established case law places a greater burden on the taxpayer to establish reasonable reliance.

In this regard, it has been held that an investor was liable for negligence penalties because he could not have reasonably relied upon the advice of promoters or persons who the promoters introduced to the taxpayer as "tax professionals" because those persons were not independent of the promoters. His reliance on their advice was not reasonable because of his failure to obtain independent advice from tax professionals not connected with the shelter. *Bilyeu v. Comm.*, 55 T.C.M. (CCH) 836 (1988). Here, LIV sought the opinion of the author of the "28(a) tax haven theory" whose advice and predisposition were known from the "portfolio." *See* paragraphs 3 and 5 of the Affidavit of Stephen L. Newman, Appendix p. 860A. Mr. Danielson was retained to incorporate LIV and became its first president. Appendix p. 518A. Rex Danielson, his son, served as Secretary, Treasurer, and Director of LIV from March 1981 through all years at issue in this proceeding. Stipulation 7, Appendix 318A. The VIBIR submits that Mr. Gustave A. Danielson was not independent of the promoter—he was the promoter.

The penalty has been sustained in the face of similar facts where the petitioner testified that he sought advice from an attorney or an accountant, but there was no evidence that either an attorney or an accountant advised the petitioner that the scheme would produce the desired tax advantages. *Brown v. Comm.*, 343 T.C.M. (CCH) 1322, 1324 (1982). In *Brown*, which involved a "family trust," in considering that both petitioners were well educated the Court found it difficult to believe that they could have envisioned the Trust as anything other than a flagrant tax avoidance scheme. *Id.*

The opinions proffered by LIV contain numerous caveats and potential problems associated with "28(a) tax haven theory." To the extent that one could draw a reasonable conclusion from these documents, it was that the entire scheme was subject to attack on numerous grounds, would certainly be challenged by the taxing authorities and was unlikely to survive judicial review. Indeed, Mr. Danielson's letter to Governor King in 1975, Appendix p. 896A, and his previously published work (Affidavit of Stephen L. Newman, Appendix p. 860A) reach the same conclusion as that asserted by the VIBIR in its deficiency notices—the position upheld by the Court of Appeals in *Danbury*.

LIV has failed to meet its burden of proof to disprove both intentional disregard of Rev. Rul. 80-40 and negligence. On the record in this case, the penalty applies as matter of law.